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Opinion on the financial statements of Direct Line Insurance Group plc

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2013 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("**IFRSs**") as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The financial statements comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated and Parent Company balance sheets, the consolidated and Parent Company cash flow statements, the consolidated and Parent Company statements of changes in equity and the related notes 1 to 40 on the consolidated financial statements, and the related notes 1 to 16 on the Company financial statements. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Separate opinion in relation to IFRSs as issued by the IASB

As explained in note 1 to the consolidated financial statements, in addition to complying with its legal obligation to apply IFRSs as adopted by the European Union, the Group has also applied IFRSs as issued by the International Accounting Standards Board ("**IASB**").

In our opinion the Group financial statements comply with IFRSs as issued by the IASB.

Going concern

As required by the Listing Rules we have reviewed the Directors' statement on page 102 that the Group is a going concern. We confirm that:

- we have concluded that the Directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team.

Risk	How the scope of our audit responded to the risk
The methodology and assumptions used in setting insurance reserves The determination of the value of the insurance reserves requires significant judgment in the selection of key assumptions and methodology. Management makes significant judgement in respect of the trends in bodily injury claims frequency and severity, the propensity for large claims to settle as PPOs, the Ogden discount rate consultation and other regulatory developments.	We have tested the design and implementation and operating effectiveness of the key controls over the end to end reserving process engaging our internal actuarial specialists where appropriate. In addition we have: • tested the completeness and accuracy of the underlying data used; • considered the suitability of the methodology used in setting insurance reserves; and • challenged management's key assumptions and judgements against industry benchmarks. Our work included assessing whether the reserving methodology has been applied consistently across periods. We have also performed work to understand the sensitivity of insurance reserves to changes in key assumptions and methodology.
The valuation of investments including complex financial instruments and their accounting treatment in accordance with IAS 39 and IFRS 13 The valuation of financial investments held at fair value utilises a range of inputs. Many of the inputs required can be obtained from readily available, liquid market prices and rates. Where observable market data is not available, for example, when determining the valuation of investment property, estimates must be developed based on the most appropriate source data and are subject to significant judgement.	We have performed audit procedures over the valuation and accounting of investments held by the Group. We have tested the design and implementation and operating effectiveness of the key controls over the investment valuation process. On a sample basis we have tested their valuation at the year end. We also performed a review of sources and systems used by the Group for valuation and compared valuations to those obtained from more than one independent source or recalculated them. We also engaged our valuation specialists where appropriate and checked that the disclosure requirements of IAS 39 and IFRS 13 were appropriately addressed. We have also tested the Group's compliance with the accounting rules for complex financial instruments.

Risk	How the scope of our audit responded to the risk
Transformation projects There is a risk that the business transformation programmes undertaken by the Group could negatively impact the internal financial reporting control environment, in particular in areas of the business where there has been significant headcount reduction or new processes and procedures. There is a risk that there may no longer be an appropriate level of review and adequate segregation of duties.	We have tested the design and implementation and operating effectiveness of key business processes that have been subject to change. We have tested to determine whether appropriate segregation of duties exists within the Group's system of internal controls. For example, the procedures included an assessment of the wider implementation of the new claims system.
Reinsurance asset valuation The valuation of the reinsurance asset in respect of the ceded part of the insurance reserves requires significant judgement to reflect the counterparty risk exposure to long-term assets arising from PPOs.	We have tested the design and implementation and operating effectiveness of the key controls over the reinsurance asset valuation process. We have challenged management's key assumptions over counterparty risk and the calculation methodology, including a comparison of the underlying credit ratings for key reinsurance counterparties to independent sources. We have also considered the consistency of the approach with the prior year.
Revenue recognition International Standard on Auditing 240 (UK and Ireland) state this risk must always be treated as significant. We focus on the completeness of the revenue recorded in the financial statements and the flow of premium information from the underwriting systems to the financial reporting ledger.	We have tested the design and implementation and operating effectiveness of the key controls over revenue recognition, focusing on the flow of information from the underwriting systems to the financial reporting ledger. In addition, we performed substantive analytical testing procedures on the gross and unearned premium balances.

The Audit Committee's consideration of these risks is set out on page 67.

Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

We determined materiality for the Group to be £40 million, which is below 10% of normalised pre-tax profit, and below 1.5% of equity. Pre-tax profit was normalised by taking the average pre-tax profit from ongoing operations, which excludes the impact of discontinued activities and the transformation costs, for current year and the previous two years to exclude the effect of year-on-year volatility from our determination.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £800,000, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

The scope of our group audit was determined by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the risks of material misstatement at the Group level. Based on that assessment, we focused our group audit scope on the audit work at three primary operating locations the UK, Italy and Germany.

Four entities at these locations were subject to a full audit, a further two were subject to an audit of specified account balances where the extent of our testing was based on our assessment of the risks of material misstatement and of the materiality of the Group's operations at those locations. These six entities represent the principal business units and account for 98% of the Group's net assets, 99% of the Group's revenue and 95% of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above. Our audit work at the three locations was executed at levels of materiality applicable to each individual entity which were lower than Group materiality.

At the Parent Company level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specified account balances.

The group audit team followed a programme of planned visits that has been designed so that the Senior Statutory Auditor visits each of the locations where the group audit scope was focused at least once a year.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

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

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

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of Directors' remuneration have not been made or the part of the Directors' remuneration report to be audited is not in agreement with the accounting records and returns. We have nothing to report arising from these matters.

Corporate governance statement

Under the Listing Rules we are also required to review the part of the corporate governance statement relating to the Company's compliance with nine provisions of the UK Corporate Governance Code. We have nothing to report arising from our review.

Our duty to read other information in the Annual Report

Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the Directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements.

Respective responsibilities of Directors and auditor

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team, strategically focused second partner reviews and independent partner reviews.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and the Parent Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

David Rush (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
25 February 2014

Consolidated income statement
For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Gross earned premium	5	**3,896.3**	4,048.5
Reinsurance premium ceded	5	**(373.0)**	(326.5)
Net earned premium	5	**3,523.3**	3,722.0
Investment return	6	**221.1**	281.8
Instalment income		**117.8**	125.4
Other operating income	7	**62.4**	73.3
Total income		**3,924.6**	4,202.5
Insurance claims	8	**(2,334.8)**	(2,875.3)
Insurance claims recoverable from reinsurers	8	**180.5**	451.0
Net insurance claims	8	**(2,154.3)**	(2,424.3)
Commission expenses	9	**(392.4)**	(452.9)
Operating expenses	10	**(928.3)**	(1,047.5)
Total expenses		**(1,320.7)**	(1,500.4)
Operating profit		**449.6**	277.8
Finance costs	11	**(37.7)**	(28.7)
Gain on disposal of subsidiary	19	**12.0**	–
Profit before tax		**423.9**	249.1
Tax charge	12	**(111.1)**	(64.8)
Profit for the year attributable to owners of the Company		**312.8**	184.3

	Notes	2013	2012
Earnings per share:			
Basic (pence)	15	**20.9**	12.3
Diluted (pence)	15	**20.8**	12.3

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2013

	Notes	**2013 £m**	2012 £m
Profit for the year		**312.8**	184.3
Other comprehensive (loss) / income			
Items that will not be reclassified subsequently to profit or loss:			
Actuarial loss on defined benefit pension scheme	32	**(6.9)**	(3.4)
Tax relating to items not reclassified		**1.5**	0.6
		(5.4)	(2.8)
Items that may be reclassified subsequently to profit or loss:			
Exchange differences on translation of foreign operations		**(4.9)**	(2.4)
Fair value (loss) / gain on available-for-sale investments	28	**(108.2)**	109.9
Less: realised net gains on available-for-sale investments included in income statement	28	**(25.7)**	(89.5)
Tax relating to items that may be reclassified		**33.9**	1.3
		(104.9)	19.3
Other comprehensive (loss) / income for the year net of tax		**(110.3)**	16.5
Total comprehensive income for the year attributable to owners of the Company		**202.5**	200.8

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Financial statements

Consolidated balance sheet

As at 31 December 2013

	Notes	2013 £m	2012 £m
Assets			
Goodwill and other intangible assets	16	**500.1**	421.5
Property, plant and equipment	17	**102.3**	92.4
Investment property	18	**223.4**	128.9
Reinsurance assets	20	**1,011.0**	1,102.0
Deferred tax assets	13	**19.3**	22.5
Current tax assets	12	**1.3**	5.5
Deferred acquisition costs	21	**321.5**	327.6
Insurance and other receivables	22	**1,122.0**	1,164.0
Prepayments, accrued income and other assets		**95.7**	82.6
Derivative financial instruments	23	**40.7**	37.5
Retirement benefit asset	32	**–**	2.5
Financial investments	24	**7,441.2**	7,801.5
Cash and cash equivalents	25	**908.3**	1,508.4
Assets held for sale	26	**1.0**	1.0
Total assets		**11,787.8**	12,697.9
Equity		**2,790.0**	2,831.6
Liabilities			
Subordinated liabilities	29	**486.6**	787.5
Insurance liabilities	30	**5,757.4**	6,398.5
Unearned premium reserve	30	**1,818.7**	1,872.9
Retirement benefit obligations	32	**2.0**	–
Borrowings	25	**55.1**	90.9
Derivative financial instruments	23	**19.3**	6.5
Trade and other payables including insurance payables	34	**818.3**	654.6
Deferred tax liabilities	13	**19.3**	20.9
Current tax liabilities	12	**21.1**	34.5
Total liabilities		**8,997.8**	9,866.3
Total equity and liabilities		**11,787.8**	12,697.9

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 25 February 2014. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Consolidated statement of changes in equity

For the year ended 31 December 2013

	Share capital £m	Employee trust shares £m	Capital redemption reserve £m	Revaluation reserve £m	Non-distributable reserve £m	Foreign exchange translation reserve £m	Retained earnings £m	Total shareholders equity £m
Balance at 1 January 2012	1,500.0	–	100.0	137.1	30.3	6.4	1,839.0	3,612.8
Profit for the year	–	–	–	–	–	–	184.3	184.3
Other comprehensive income / (loss)	–	–	–	21.7	–	(2.4)	(2.8)	16.5
Dividends	–	–	–	–	–	–	(1,000.0)	(1,000.0)
Transfer to non-distributable reserve	–	–	–	–	32.9	–	(32.9)	–
Capital contribution[1]	–	–	–	–	–	–	30.9	30.9
Movement in net assets of Direct Line Versicherung AG[2]	–	–	–	–	–	1.0	(9.2)	(8.2)
Shares acquired by employee trusts	–	(5.0)	–	–	–	–	–	(5.0)
Credit to equity for equity-settled share-based payments	–	–	–	–	–	–	0.3	0.3
Issue of own shares	150.0	–	–	–	–	–	–	150.0
Own shares redeemed	(1,500.0)	–	1,350.0	–	–	–	–	(150.0)
Balance at 31 December 2012	150.0	(5.0)	1,450.0	158.8	63.2	5.0	1,009.6	2,831.6
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**312.8**	**312.8**
Other comprehensive loss	**–**	**–**	**–**	**(100.0)**	**–**	**(4.9)**	**(5.4)**	**(110.3)**
Dividends	**–**	**–**	**–**	**–**	**–**	**–**	**(242.7)**	**(242.7)**
Transfer to non-distributable reserve	**–**	**–**	**–**	**–**	**29.6**	**–**	**(29.6)**	**–**
Shares acquired by employee trusts	**–**	**(5.7)**	**–**	**–**	**–**	**–**	**–**	**(5.7)**
Credit to equity for equity-settled share-based payments	**–**	**–**	**–**	**–**	**–**	**–**	**4.1**	**4.1**
Shares distributed by employee trusts	**–**	**0.5**	**–**	**–**	**–**	**–**	**(0.5)**	**–**
Deferred tax on share-based payments	**–**	**–**	**–**	**–**	**–**	**–**	**0.2**	**0.2**
Balance at 31 December 2013	**150.0**	**(10.2)**	**1,450.0**	**58.8**	**92.8**	**0.1**	**1,048.5**	**2,790.0**

Notes:

1. See basis of preparation in note 1.
2. The movements in net assets of Direct Line Versicherung AG ceased on 2 April 2012, see note 1.

	Non-controlling interest £m
Balance at 1 January 2012	258.5
Transfer to subordinated liabilities	(258.5)
Balance at 31 December 2012 and 31 December 2013	**–**

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Financial statements

Consolidated cash flow statement

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Net cash used by operating activities before investment of insurance assets	35	**(307.0)**	(966.0)
Cash generated from investment of insurance assets	35	**433.0**	2,004.8
Net cash generated from operating activities		**126.0**	1,038.8
Cash flows from investing activities			
Purchases of property, plant and equipment	17	**(39.1)**	(63.7)
Purchases of intangible assets	16	**(115.5)**	(96.6)
Net cash flows from disposal of subsidiary	19	**18.8**	–
Cash flows from net investment hedges		**(9.5)**	6.1
Net cash used by investing activities		**(145.3)**	(154.2)
Cash flows from financing activities			
Dividends paid	14	**(242.7)**	(1,000.0)
Repayment of borrowings and subordinated liabilities		**(258.5)**	(246.4)
Proceeds on issue of subordinated liabilities		**–**	493.0
Finance costs		**(37.8)**	(16.1)
Purchase of employee trust shares		**(5.7)**	(5.0)
Net cash used by financing activities		**(544.7)**	(774.5)
Net (decrease) / increase in cash and cash equivalents		**(564.0)**	110.1
Cash and cash equivalents at the beginning of the year	25	**1,417.5**	1,309.6
Effect of foreign exchange rate changes		**(0.3)**	(2.2)
Cash and cash equivalents at the end of the year	25	**853.2**	1,417.5

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Corporate information

Direct Line Insurance Group plc is a public limited company incorporated in the United Kingdom. The address of the registered office is Churchill Court, Westmoreland Road, Bromley, BR1 1DP, England.

1. Accounting policies

Basis of preparation

As required by the Companies Act 2006 and Article 4 of the EU IAS Regulation, the consolidated financial statements are prepared in accordance with IFRSs issued by the IASB as adopted by the EU. The financial statements have been prepared in accordance with and full compliance with IFRSs as issued by the IASB.

The consolidated financial statements are prepared on the historical cost basis except for available-for-sale ("AFS") financial assets, investment property and derivative financial instruments, which are measured at fair value.

The Company's financial statements and the Group's consolidated financial statements are presented in Pounds Sterling, which is the functional currency of the Company.

The Group in its current structure was formed on 2 April 2012 when the Company acquired Direct Line Versicherung AG from a former fellow subsidiary of The Royal Bank of Scotland Group plc. Therefore the basis of preparation represents a reorganisation of entities under common control, which is outside the scope of IFRS 3 'Business Combinations'. Accordingly, as permitted by IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', it has been accounted for as a group reconstruction as described in Financial Reporting Standard 6, 'Acquisitions and Mergers'. The consolidated financial statements have been prepared as if the transaction that gave rise to the formation of the Group had taken place at the beginning of 2011. Under these principles, the consolidated financial statements have been prepared as if the Company were the holding company of Direct Line Versicherung AG from 1 January 2011.

As part of the divestment from RBS Group, the treatment of expenses incurred by RBS Group on behalf of the Group changed. Up until 30 June 2012, only some of these expenses were recharged to the Group by RBS Group. From 1 July 2012, some of the services previously provided by RBS Group have been brought in-house and so the related expenses are now incurred directly by the Group and reflected in expenses in the income statement; other services are still provided by RBS Group under transitional services agreements and the related expenses are charged to the Group. In order to aid comparability, the Group's accounting policy was changed on 1 January 2011 so that all expenses were included within the income statement. For the avoidance of doubt, this includes external costs incurred by the Group and costs incurred by RBS Group, irrespective of whether RBS Group recharged them to the Group. In the case of expenses incurred by RBS Group and not recharged to the Group, a capital contribution was credited to retained earnings in the statement of changes in equity to reflect this contribution from a shareholder. In addition there was a further contribution of £6.3 million in respect of overseas taxation.

The effect of the above on the Group profit for the year ended 31 December 2012 was to decrease profit after tax by £30.9 million, with an equal and opposite credit in the statement of changes in equity.

Adoption of new and revised standards

The following new or revised standards have been adopted in the year and have not had a material impact on the Group's financial statements:

IFRS 10 'Consolidated Financial Statements' replaced SIC 12 'Consolidation – Special Purpose Entities' and the consolidation elements of IAS 27 'Consolidated and Separate Financial Statements'. The new standard adopts a single definition of control: a reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity;

IAS 27 'Separate Financial Statements' was amended to delete all other aspects of the previous standard other than those dealing with separate financial statements;

IFRS 12 'Disclosure of Interests in Other Entities' covers disclosures for entities reporting under IFRS 10 and IFRS 11, replacing the requirements in IAS 28 and IAS 27. Entities are required to disclose information that helps users of financial statements evaluate the nature, risks and financial effects associated with an entity's interests in subsidiaries, associates and joint arrangements and unconsolidated structured entities;

IFRS 13 'Fair Value Measurement' sets out a single IFRS framework for defining and measuring fair value and requiring disclosures about fair value measurements;

IAS 1 'Presentation of Items of Other Comprehensive Income' requires items that will never be recognised in the income statement to be presented in other comprehensive income separately from those that are subject to subsequent reclassification;

IFRS 7 'Financial Instruments: Disclosure – Offsetting Financial Assets and Financial Liabilities' was amended to allow users to consider the impact of netting arrangements as permitted by IAS 32 (paragraph 42) on the financial statements; and

IAS 19 'Employee Benefits' was revised and requires the immediate recognition of all actuarial gains and losses eliminating the 'corridor approach'; interest costs to be calculated on the net pension liability or asset at the appropriate bond rate; and all past service costs to be recognised immediately when a scheme is curtailed or amended.

1. Accounting policies continued

1.1 Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and the entities that are controlled by the Group at 31 December 2013 and 31 December 2012. Control exists when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. In assessing if the Group controls another entity, the existence and effect of the potential voting rights that are currently exercisable or convertible are considered.

Where necessary, adjustments have been made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. The policies set out below have been applied consistently throughout the years ended 31 December 2013 and 31 December 2012 to items considered material to the consolidated financial statements.

A subsidiary acquired is included in the consolidated financial statements from the date it is controlled by the Group until the date the Group ceases to control it. On acquisition of a subsidiary, its identifiable assets, liabilities and contingent liabilities are included in the consolidated financial statements at fair value.

All intercompany transactions, balances, income and expenses between Group entities are eliminated on consolidation. The consolidated financial statements are prepared using consistent accounting policies.

1.2 Foreign currencies

The Group's consolidated financial statements are presented in Pounds Sterling which is the presentational currency of the Group. Group entities record transactions in the currency of the primary economic environment in which they operate (their functional currency), translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in the income statement except for differences that arise on hedges of net investments in foreign operations, which were reported in other comprehensive income.

Non-monetary items denominated in foreign currencies that are stated at fair value are translated into the relevant functional currency at the foreign exchange rates ruling at the dates the values are determined. Translation differences arising on non-monetary items measured at fair value are recognised in the income statement except for differences arising on AFS non-monetary financial assets, which are recognised in other comprehensive income.

Assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into Pounds Sterling at the foreign exchange rates ruling at the balance sheet date. Income and expenses of foreign operations are translated into Pounds Sterling at average exchange rates unless these do not approximate the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of a foreign operation are recognised in the consolidated statement of comprehensive income. The amount accumulated in equity is reclassified from equity to the consolidated income statement on disposal or partial disposal of a foreign operation.

1.3 Contract classification

Insurance contracts are those contracts where the Group (the insurer) has accepted significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period, unless all rights and obligations are extinguished.

1.4 Revenue recognition

Premiums earned

Insurance and reinsurance premiums comprise the total premiums receivable for the whole period of cover provided by contracts incepted during the financial year, adjusted by an unearned premium provision, which represents the proportion of the premiums incepted in prior periods and that relate to periods of insurance cover after the balance sheet date. Unearned premiums are calculated over the period of exposure under the policy, on a daily basis, 24ths basis or allowing for the estimated incidence of exposure under policies.

Premiums collected by intermediaries or other parties, but not yet received, are assessed based on estimates from underwriting or past experience, and are included in insurance premiums. Insurance premiums exclude insurance premium tax or equivalent local taxes and are shown gross of any commission payable to intermediaries or other parties.

The long-term assurance contracts that the Group wrote included whole-life and term assurance contracts that were expected to remain in force for an extended period of time. The contracts insured events associated with human life (for example, death or the occurrence of a critical illness). These were recognised as revenue when they became payable by the contract holder. Premiums were shown before the deduction of commission.

Investment return

Interest income on financial assets is determined using the effective interest rate method. The effective interest rate method is a way of calculating the amortised cost of a financial asset (or group of financial assets) and of allocating the interest income over the expected life of the asset. In the case of financial assets classified as AFS, estimates are based on the straight-line method, which is a close approximation to the effective interest rate.

Rental income from investment property is recognised in the income statement on a straight-line basis over the period of the contract. Any gains or losses arising from a change in fair value are recognised in the income statement.

Instalment income

Instalment income comprises the interest income earned on policyholder receivables, where outstanding premiums are settled by a series of instalment payments. Interest is earned using an effective interest rate method over the term of the policy.

Other operating income

Solicitors' referral fee income

Revenue relating to this activity is recognised when the service is rendered. The provision of these services is contractual and the associated cost is recognised when incurred.

Vehicle replacement referral income

Vehicle replacement referral income comprises fees in respect of referral income received when a customer or a non-fault policyholder (claimant) of another insurer has been provided with a hire vehicle from a preferred supplier.

Income is recognised immediately when the customer or claimant is provided with the hire vehicle.

Revenue from vehicle recovery and repair services

Fees in respect of services for vehicle recovery are recognised as the right to consideration, and accrue through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable.

The Group's income also comprises vehicle repair services provided to other third-party customers. Income in respect of repairs to vehicles is recognised upon completion of the service. The price is determined using market rates for the services and materials used after discounts have been deducted where applicable.

Management systems income represents the sale of tracking units, installation services and monitoring services. Revenue is recognised immediately, with the exception of the non-cancellable network subscriptions receivable in advance, which are classified as deferred income in the balance sheet and recognised on a straight-line basis over the stated term of the subscription.

Other income

Commission fee income in respect of services is recognised when a policy has been placed and incepted. Income is stated excluding applicable sales taxes.

1.5 Insurance claims

Insurance claims are recognised in the accounting period in which the loss occurs. Provision is made for the full cost of settling outstanding claims at the balance sheet date, including claims incurred but not yet reported at that date, net of salvage and subrogation recoveries. Outstanding claims provisions are not discounted for the time value of money except for claims to be settled by PPOs established under the Courts Act 2003. A UK court can award damages for future pecuniary loss in respect of personal injury or for other damages in respect of personal injury and may order that the damages are wholly or partly to take the form of PPOs. These are covered in more detail in note 2.1. Costs for both direct and indirect claims handling expenses are also included.

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. When calculating the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims (gross and net) at the balance sheet date. Also included in the estimation of outstanding claims are factors such as the potential for judicial or legislative inflation. In addition, an allowance is made for reinsurance assets deemed not recoverable.

Provisions for more recent claims make use of techniques that incorporate expected loss ratios and average claims cost (adjusted for inflation) and frequency methods. As claims mature, the provisions are increasingly driven by methods based on actual claims experience. The approach adopted takes into account the nature, type and significance of the business and the type of data available, with large claims generally being assessed separately. The data used for statistical modelling purposes is generated internally and reconciled to the accounting data.

The calculation is particularly sensitive to the estimation of the ultimate cost of claims for the particular classes of business at gross and net levels and the estimation of future claims handling costs. Actual claims experience may differ from the historical pattern on which the actuarial best estimate is based and the cost of settling individual claims may exceed that assumed. As a result, the Group sets provisions at a margin above the actuarial best estimate. This amount is recorded as claims provisions.

A liability adequacy provision is made for unexpired risks arising where the expected value of net claims and expenses attributable to the unexpired periods of policies in force at the balance sheet date exceeds the unearned premium reserve in relation to such policies after the deduction of any acquisition costs deferred and other prepaid amounts (for example, reinsurance). The expected value is determined by reference to recent experience and allowing for changes to the premium rates. The provision for unexpired risks is calculated separately by reference to classes of business that are managed together after taking account of relevant investment returns.

1.6 Reinsurance

The Group has reinsurance treaties and other reinsurance contracts that transfer significant insurance risk.

The Group cedes insurance risk by reinsurance in the normal course of business, with the arrangement and retention limits varying by product line. Outward reinsurance premiums are generally accounted for in the same accounting period as the premiums for the related direct business being reinsured. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

Reinsurance assets include balances due from reinsurance companies for ceded insurance liabilities. Amounts recoverable from reinsurers are estimated in a consistent manner with the outstanding claims provisions or settled claims associated with the reinsured policies and in accordance with the relevant reinsurance contract. Recoveries in respect of PPOs are discounted for the time value of money.

1. Accounting policies continued

A reinsurance bad debt provision is assessed in respect of reinsurance debtors, to allow for the risk that the reinsurance asset may not be collected or where the reinsurer's credit rating has been downgraded significantly. This also includes an assessment in respect of the ceded part of claims provisions to reflect the counterparty risk exposure to long-term reinsurance assets particularly in relation to periodical payments. This is affected by the Group reducing the carrying value of the asset accordingly and the impairment loss is recognised in the income statement.

1.7 Deferred acquisition costs

Acquisition costs relating to new and renewing insurance policies are matched with the earning of the premiums to which they relate. A proportion of acquisition costs incurred during the year is therefore deferred to the subsequent accounting period to match the extent to which premiums written during the year are unearned at the balance sheet date.

The principal acquisition costs deferred are direct advertising expenditure, administration costs, commission paid and costs associated with telesales and underwriting staff.

1.8 Goodwill and other intangible assets

Acquired goodwill, being the excess of the cost of an acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the subsidiary, associate or joint venture acquired, is initially recognised at cost and subsequently at cost less any accumulated impairment losses. Goodwill arising on the acquisition of subsidiaries, associates and joint ventures is included in the balance sheet category 'goodwill and other intangible assets'. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

Intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to the income statement over the assets' economic lives using methods that best reflect the pattern of economic benefits and is included in operating expenses. The estimated useful economic lives are as follows:

Software development costs	5 years

Expenditure on internally generated goodwill and brands is written off as incurred. Direct costs relating to the development of internal-use computer software and associated business processes are capitalised once technical feasibility and economic viability have been established. These costs include payroll costs, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended. During and after development, accumulated costs are reviewed for impairment against the projected benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and economic viability are expensed as incurred, as are all training costs and general overheads. The costs of licences to use computer software that is expected to generate economic benefits beyond one year are also capitalised.

1.9 Property, plant and equipment

Items of property, plant and equipment (except investment property – see accounting policy 1.11) are stated at cost less accumulated depreciation and impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to the income statement on a straight-line basis so as to write off the depreciable amount of property, plant and equipment over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Land is not depreciated. Estimated useful lives are as follows:

Freehold and long leasehold buildings	50 years or the period of the lease if shorter
Vehicles	3 years
Computer equipment	Up to 5 years
Other equipment, including property adaptation costs	2 to 15 years

The gain or loss arising from the derecognition of an item of property, plant and equipment is determined as the difference between the disposal proceeds, if any, and the carrying amount of the item.

1.10 Impairment of intangible assets, goodwill and property, plant and equipment

At each reporting date, the Group assesses whether there is any indication that its intangible assets, goodwill or property, plant and equipment are impaired. If any such indication exists, the Group estimates the recoverable amount of the asset and the impairment loss, if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. If an asset does not generate cash flows that are independent of those of other assets or groups of assets, the recoverable amount is determined for the cash-generating unit ("**CGU**") to which the asset belongs. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. Value in use is the present value of future cash flows from the asset or CGU, discounted at a rate that reflects market interest rates, adjusted for risks specific to the asset or CGU that have not been reflected in the estimation of future cash flows.

If the recoverable amount of an intangible or a tangible asset is less than its carrying value, an impairment loss is recognised immediately in the income statement and the carrying value of the asset is reduced by the amount of the impairment loss.

A reversal of an impairment loss on intangible assets or property, plant and equipment is recognised as it arises provided the increased carrying value does not exceed the carrying amount that would have been determined had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

1.11 Investment property

Investment property comprises freehold and long-leasehold properties that are held to earn rentals or for capital appreciation or both. Investment property is not depreciated, but is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices for similar properties adjusted for the specific characteristics of each property. Any gain or loss arising from a change in fair value is recognised in the income statement.

Investment property is derecognised either when it has been disposed of, or permanently withdrawn from use and no future economic benefit is expected from disposal. Any gains or losses on the retirement or disposal of investment property are recognised in the income statement in the year of retirement or disposal.

1.12 Financial assets

Financial assets are classified as held-to-maturity, AFS, designated at fair value through profit or loss, or loans and receivables. The Group only has AFS financial assets and loans and receivables.

AFS

Financial assets that are not classified as loans and receivables are classified as AFS. Financial assets can be designated as AFS on initial recognition. AFS financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Impairment losses and exchange differences resulting from retranslating the amortised cost of foreign currency monetary AFS financial assets are recognised in the income statement, together with interest calculated using the effective interest rate method. Other changes in the fair value of AFS financial assets are reported in a separate component of shareholders' equity until disposal, when the cumulative gain or loss is recognised in the income statement.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; all other regular way purchases are recognised on trade date.

A financial asset is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The appropriate quoted market price for an asset held is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (for example, a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate.

The valuation methodology described above uses observable market data.

If the market for a financial asset is not active, the Group establishes the fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties (if available), reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the Group uses that technique.

The fair value of other investments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument are reliably measurable if:

(a) the variability in the range of reasonable fair value estimates is not significant for that instrument; or

(b) the probabilities of the various estimates within the range can reasonably be assessed and used in estimating fair value.

Loans and receivables

Non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables, except those that are classified as AFS. Loans and receivables are initially recognised at fair value plus directly related transaction costs and are subsequently measured at amortised cost using the effective interest rate method less any impairment losses.

Insurance receivables comprise outstanding insurance premiums where the policyholders have elected to pay in instalments, or amounts due from third parties where they have collected or are due to collect the money from the policyholder.

Impairment of financial assets

At each balance sheet date the Group assesses whether there is any objective evidence that a financial asset or group of financial assets classified as AFS or loans and receivables is impaired. A financial asset or portfolio of financial assets is impaired and an impairment loss incurred, if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

AFS

When a decline in the fair value of a financial asset classified as AFS has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss is removed from equity and recognised in the income statement. The loss is measured as the difference between the amortised cost of the financial asset and its current fair value. Impairment losses on AFS equity instruments are not reversed through profit or loss, but those on AFS debt instruments are reversed, if there is an increase in fair value that is objectively related to a subsequent event. Subsequent increases in the fair value of AFS other investment funds were recognised in equity.

Loans and receivables

If there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables has been incurred, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets, discounted at the effective interest rate of the instrument at initial recognition.

1. Accounting policies continued

Impairment losses are assessed individually where significant or collectively for assets that are not individually significant.

Impairment losses are recognised in the income statement and the carrying amount of the financial asset or group of financial assets is reduced by establishing an allowance for the impairment losses. If in a subsequent period the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance.

For amounts due from policyholders, the bad debt provision is calculated based upon prior loss experience. For all balances outstanding in excess of three months, a bad debt provision is made. Where a policy is subsequently cancelled, the outstanding debt that is overdue is charged to the income statement and the bad debt provision is released back to the income statement.

Derivatives and hedging

Derivative financial instruments are recognised initially, and subsequently measured, at fair value. Derivative fair values are determined from quoted prices in active markets where available. Where there is no active market for an instrument, fair value is derived from prices for the derivative's components using appropriate pricing or valuation models.

Gains and losses arising from changes in the fair value of a derivative are recognised as they arise in the income statement unless the derivative is the hedging instrument in a qualifying hedge. The Group enters into a number of hedge relationships for cash flow and fair value hedges. Previously the Group entered into hedge relationships for net investments.

Hedge relationships are formally documented at inception. The documentation identifies the hedged item and the hedging instrument and details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge. If the hedge is not highly effective in offsetting changes in cash flows and fair values attributable to the hedged risk, consistent with the documented risk management strategy, or if the hedging instrument expires or is sold, terminated or exercised, hedge accounting is discontinued.

In the hedge of a net investment in a foreign operation, the portion of foreign exchange differences arising on the hedging instrument determined to be an effective hedge were recognised directly in equity, where they remain until disposal or partial disposal of the associated subsidiaries. Any ineffective portion was recognised in the income statement. Non-derivative financial liabilities as well as derivatives may have been the hedging instrument in a net investment hedge.

In a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised directly in equity. Any ineffective portion is recognised in the income statement.

In a fair value hedge, the gain or loss on the hedging instrument is recognised in the income statement. The gain or loss on the hedged item attributable to the hedged risk is recognised in the income statement and, where the hedged item is measured at amortised cost, adjusts the carrying amount of the hedged item.

Derecognition of financial assets

A financial asset is derecognised when the rights to receive the cash flows from that asset have expired or when the Group has transferred its rights to receive cash flows from the asset and has transferred substantially all the risk and rewards of ownership of the asset.

1.13 Cash and cash equivalents

Cash and cash equivalents comprise cash in hand and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

Borrowings, comprising bank overdrafts, are measured at amortised cost using the effective interest rate method.

1.14 Financial liabilities

Financial liabilities are initially recognised at fair value net of transaction costs incurred. Other than derivatives which are recognised and measured at fair value, all other financial liabilities are subsequently measured at amortised cost using the effective interest rate method.

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

1.15 Subordinated liabilities

Subordinated liabilities comprise subordinated dated loan notes and undated loans, which are initially measured at the consideration received less related transaction costs. Subsequently, subordinated liabilities are measured at amortised cost using the effective interest rate method.

1.16 Provisions

The Group recognises a provision for a present legal or constructive obligation from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount can be reliably estimated.

The Group makes provision for all insurance industry levies, such as the Financial Services Compensation Scheme and Motor Insurance Bureau.

When the Group has an onerous contract, it recognises the present obligation under the contract as a provision. A contract is onerous when the unavoidable costs of meeting the contractual obligations exceed the expected future economic benefit. In respect of leasehold properties, a provision is recognised when the Group has a detailed formal plan to vacate the leasehold property, or significantly reduce its level of occupancy, the plan has been communicated to those affected and the future property costs under the lease exceed future economic benefits.

Restructuring provisions are made, including redundancy costs, when the Group has a constructive obligation to restructure. An obligation exists when the Group has a detailed formal plan and has communicated the plan to those affected.

1.17 Leases

Payments made under operating leases are charged to the income statement on a straight-line basis over the term of the lease.

1.18 Pensions and other post-retirement benefits
The Group provides post-retirement benefits in the form of pensions and healthcare plans to eligible employees.

Contributions to the Group's defined contribution pension scheme are recognised in the income statement when payable.

The Group's defined benefit pension scheme, as described in note 32, was closed in 2003. Scheme liabilities are measured on an actuarial basis, using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high-quality corporate bond of equivalent term and currency to the scheme liabilities.

Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). The current service cost and any past service costs together with the net interest on net pension liability or asset, is charged or credited to operating expenses. Actuarial gains and losses are recognised in full in the period in which they occur outside the income statement and presented in other comprehensive income under 'Items that will not be reclassified subsequently to profit or loss'.

1.19 Taxation
The tax charge or credit represents the sum of the tax currently payable or receivable and deferred tax.

The current tax charge is based on the taxable profits for the year as determined in accordance with the relevant tax legislation, after any adjustments in respect of prior years. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

Provision for taxation is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date, and is allocated over profits before taxation and amounts charged or credited to components of other comprehensive income and equity, as appropriate.

Deferred taxation is accounted for in full using the balance sheet liability method on all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes.

Deferred tax liabilities are generally recognised for all taxable temporary timing differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax assets are reviewed at each balance sheet date and reduced to the extent that it is probable that they will not be recovered.

Deferred tax assets and liabilities are calculated at the tax rates expected to apply when the assets are realised or liabilities are settled based on laws and rates that have been enacted or substantively enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited to other comprehensive income, in which case the deferred tax is also dealt with in other comprehensive income.

1.20 Share-based payments
The Group operates a number of share-based compensation plans under which it awards Company shares and share options to its employees. Such awards are generally subject to vesting conditions that vary the amount of cash or shares to which an employee is entitled.

Vesting conditions include service conditions (requiring the employee to complete a specified period of service) and performance conditions (requiring the employee to meet specified performance targets).

The fair value of options granted is estimated using valuation techniques which incorporate exercise price, term, risk-free interest rates, the current share price and its expected volatility.

The cost of employee services received in exchange for an award of shares or share options granted is measured by reference to the fair value of the shares or share options on the date the award is granted and takes into account non-vesting conditions and market performance conditions (conditions related to the market price of the Company's shares).

The cost is expensed on a straight-line basis over the vesting period (the period during which all the specified vesting conditions must be satisfied) with a corresponding increase in equity in an equity-settled award, or a corresponding liability in a cash-settled award. The cost is adjusted for vesting conditions (other than market performance conditions) so as to reflect the number of shares or share options that actually vest.

The cancellation of an award through failure to meet non-vesting conditions triggers an immediate expense for any unrecognised element of the cost of an award.

1.21 Capital instruments
The Group classifies a financial instrument that it issues as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms, or as equity if it evidences a residual interest in the assets of the Group after the deduction of liabilities.

The consideration for any Ordinary Share of the Company purchased by the Group for the benefit of the employee trusts is deducted from equity.

1.22 Dividends
Interim dividends on Ordinary Shares are recognised in equity in the period in which they are paid. Final dividends on Ordinary Shares are recognised when they have been approved at the AGM.

1. Accounting policies continued

1.23 Accounting developments

In December 2011, the IASB amended IAS 32 'Financial Instruments: Presentation' for the section dealing with offsetting a financial asset and a financial liability. Effective for annual periods beginning on or after 1 January 2014, to be applied retrospectively, this amendment is not expected to have any effect on the Group.

IFRS 9 'Financial Instruments' is a new standard that is intended to replace IAS 39 'Financial instruments: Recognition and Measurement' in its entirety. The replacement project consists of three planned phases and will impact the measurement and disclosures of financial instruments.

The first phase will change the basis and treatment of the classification and measurement of financial assets and financial liabilities.

The second phase is the impairment methodology and a revised exposure draft in March 2013 has proposed a more forward-thinking impairment model that reflects expected credit losses as opposed to the incurred loss model in IAS 39.

The final phase will cover hedge accounting for both general hedge accounting and macro hedge accounting.

There is currently no mandatory effective date for IFRS 9.

2. Critical accounting estimates and judgements

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial information. The Group's principal accounting policies are set out on pages 113 to 120. UK company law and IFRSs require the Directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the absence of an applicable standard or interpretation, IAS 8 requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of Financial Statements. The judgements and assumptions involved in the Group's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.

2.1 General insurance: outstanding claims provisions and related reinsurance recoveries

The Group makes provision for the full cost of outstanding claims from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and claims handling provision. Outstanding claims provisions net of related reinsurance recoveries and liability adequacy provision at 31 December 2013 amounted to £4,840.1 million (2012: £5,377.6 million).

Claims reserves are assessed separately for large and attritional claims typically using normal actuarial methods of projection. Key judgements in this assessment include the selection of specific methods as well as assumptions for claims frequency and severity through the review of historical claims and emerging trends. The corresponding reinsurance recoveries are also calculated on an equivalent basis as discussed in note 1.6.

The most common method of settling bodily injury claims is by a lump sum paid to the claimant and, in the cases where this includes an element of indemnity for recurring costs such as loss of earnings or ongoing medical care, settlement normally occurs using a standardised Ogden annuity factor at a discount rate of 2.5%. This is normally referred to as the Ogden discount rate. Other estimates are also required for case management expenses, loss of pension, court protection fees, alterations to accommodation and transportation fees.

In August 2012, the MoJ announced a review of the approach to setting the Ogden discount rate within the existing legal framework in light of the current economic climate. The consultation has now taken place and the results are pending. In addition, in February 2013, a further consultation was initiated on the legal framework within which the rate is set as well as consideration of the usage of PPOs as a form of settlement. The latest consultation closed in June 2013 and the results are pending.

The Group holds provisions for a reduction in the Ogden discount rate at 31 December 2013 to 1.5% (2012: 1.5%). Details of sensitivity analysis to the assumed Ogden discount rate are shown in 3.3.1.

PPOs give rise to additional claims costs which are in excess of those calculated based on the Ogden tables and discounting is applied to the total cost of the PPO and not just the additional cost. The table below analyses the outstanding PPO claims provisions on a discounted and an undiscounted basis at 31 December 2013 and 31 December 2012. These represent the total cost of PPOs rather than any costs in excess of purely Ogden-based settlement.

At 31 December	**Discounted 2013 £m**	**Undiscounted 2013 £m**	Discounted 2012 £m	Undiscounted 2012 £m
Gross claims				
Approved PPO claims provisions	**367.7**	**1,099.9**	300.5	918.3
Anticipated PPOs	**631.2**	**1,935.7**	962.9	2,778.6
Total	**998.9**	**3,035.6**	1,263.4	3,696.9
Reinsurance				
Approved PPO claims provisions	**(204.9)**	**(656.3)**	(175.5)	(573.3)
Anticipated PPOs	**(165.9)**	**(707.9)**	(270.0)	(1,074.4)
Total	**(370.8)**	**(1,364.2)**	(445.5)	(1,647.7)
Net of reinsurance				
Approved PPO claims provisions	**162.8**	**443.6**	125.0	345.0
Anticipated PPOs	**465.3**	**1,227.8**	692.9	1,704.2
Total	**628.1**	**1,671.4**	817.9	2,049.2

The provision for PPOs have been categorised as either claims which have already settled as PPOs (approved PPO claims provisions) and those expected to settle as PPOs in the future (anticipated PPOs). Anticipated PPOs consists of both existing large loss case reserves including allowances for development as well as claims yet to be reported to the Group. Reinsurance is applied at claim level and the net cash flows are discounted for the time value of money. The discount rate is consistent with the long duration of the claims payments and the assumed future indexation of the claims payments.

In the majority of cases, the inflation index agreed in the settlement is the Annual Survey of Hours and Earnings inflation published by the Office for National Statistics, for which the long-term rate is assumed to be 4.0% (2012: 4.0%). The rate of interest used for the calculation of present values is 4.0% (2012: 4.0%), which results in a real discount rate of 0.0% (2012: 0.0%).

Details of sensitivity analysis to the discount rate applied to PPO claims are shown in note 3.3.1.

2.2 Impairment provisions – financial assets

AFS

The Group determines that AFS financial assets are impaired when there is objective evidence that an event or events since initial recognition of the assets have adversely affected the amount or timing of future cash flows from the asset. The determination of which events could have adversely affected the amount or timing of future cash flows from the asset requires judgement. In making this judgement, the Group evaluates, among other factors, the normal price volatility of the financial asset, the financial health of the investee, industry and sector performance, changes in technology and operational and financing cash flow or where there has been a significant or prolonged decline in the fair value of the asset below its cost. Impairment may be appropriate when there is evidence of deterioration in these factors.

On a quarterly basis, the Group reviews whether there is any objective evidence that the direct investments in AFS debt securities are impaired based on the following criteria:

- price performance of a particular AFS debt security, or group of AFS debt securities, demonstrating an adverse trend compared to the market as a whole;
- adverse movements in the credit rating for corporate debt;
- actual, or imminent, default on coupon interest or nominal; or
- offer on buyback of perpetual bonds below par value.

Impairment provision charges on AFS financial assets at 31 December 2013 amounted to £nil (2012: £nil).

Had all the declines in AFS asset values met the criteria above at 31 December 2013, the Group would suffer a further £40.4 million loss (2012: £21.5 million loss), being the transfer of the total AFS reserve for unrealised losses to the income statement. These movements represent mark-to-market movements and where there is no objective evidence of any loss events that could affect future cash flows, no impairments are recorded for these movements.

2. Critical accounting estimates and judgements continued

2.3 Fair value

Financial assets classified as AFS debt securities are recognised in the financial statements at fair value. The fair value of all AFS debt securities was determined using observable market input and at 31 December 2013 amounted to £7,005.5 million (2012: £7,156.5 million).

Freehold and long leasehold properties that are classified as investment properties are recognised in the financial statements at fair value. The fair value at 31 December 2013 amounted to £223.4 million (2012: £128.9 million) was determined using a valuation model that includes inputs that are unobservable.

Estimation of the fair value of assets and liabilities

In estimating the fair value of financial assets and investment properties the methods and assumptions used by the Group incorporate:

Financial assets and liabilities

For fixed maturity securities, fair values are generally based upon quoted market prices. Where market prices are not readily available, fair values are estimated using values obtained from quoted market prices of comparable securities.

Investment property

Investment property is recorded at fair value, measured by independent valuers who hold a recognised and relevant professional qualifications. The valuation model is driven predominantly by unobservable inputs, as although in part the valuations are compared with recent market transactions for similar properties, they are adjusted for the specific characteristics of each property.

For disclosure purposes, fair value measurements are classified as Level 1, 2 or 3 based on the degree to which fair value is observable:

Level 1 financial assets are measured in whole or in part by reference to published quotes in an active market. In an active market quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Level 2 financial assets are measured using a valuation technique based on assumptions that are supported by prices from observable current market transactions. These are assets for which pricing is obtained via pricing services, but where prices have not been determined in an active market, or financial assets with fair values based on broker quotes, investments in private equity funds with fair values obtained via fund managers or assets that are valued using the Group's own models whereby the majority of assumptions are market-observable.

Level 3 fair value measurements used for investment properties are those derived from a valuation technique that include inputs for the asset that are unobservable.

2.4 Deferred acquisition costs

The Group defers a proportion of acquisition costs incurred during the year to subsequent accounting periods. Management use estimation techniques to determine the level of costs to be deferred, by category of business. Judgement is used to determine the types of cost that can be deferred and these are referred to in note 1.7. The total deferred acquisition costs at 31 December 2013 amounted to £321.5 million (2012: £327.6 million). During 2013, the Group reviewed these costs included in the calculation of deferred acquisition costs and considers them to be appropriate, and has determined that they are recoverable.

2.5 Goodwill

The Group capitalises goodwill arising on the acquisition of businesses as discussed in note 1.8. The carrying value of goodwill at 31 December 2013 was £211.0 million (2012: £211.0 million).

Goodwill is the excess of the cost of an acquired business over the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices and those non-financial assets where valuations reflect estimates of market conditions, such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance. Goodwill is not amortised but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the Group's CGUs or groups of CGUs expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a CGU or group of CGUs with its recoverable amount. The recoverable amount is the higher of the CGU's fair value and its value in use. Value in use is the present value of expected future cash flows from the CGU or group of CGUs. Fair value is the amount obtainable from the sale of the CGU in an arm's length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgemental areas: the preparation of the five-year strategic plan and the extrapolation of cash flow forecasts beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of CGUs; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details of a sensitivity analysis on the recoverable amount in excess of carrying value are shown in note 16.

2.6 Property, plant and equipment
The Group does not revalue property, plant and equipment. However it takes appropriate steps to consider whether the aggregate value of property, plant and equipment exceeds the balance sheet carrying value of such items.

The Group is satisfied that the aggregate value of property, plant and equipment are not less than their carrying value.

3. Risk management
3.1 Enterprise-Wide Risk Management framework
The ERM framework within the Group is designed to ensure that risk management is a forward-looking discipline, focused on facilitating appropriate and fair outcomes on a consistent and reliable basis for all stakeholders. The ERM process provides the Group with a consistent and holistic view of risk management. Further information can be found in the Risk management section of the Strategic report on page 22.

3.2 Risk and capital management modelling
The Board has ultimate responsibility for ensuring that the Group has sufficient funds to meet its liabilities as they fall due. The Group carries out detailed modelling of its assets, liabilities and the key risks to which these are exposed. This modelling includes the Group's own assessment of its capital requirements for solvency purposes. The assessment is submitted to the PRA as the ICA in respect of its UK regulated entities. The ICA quantifies the insurance, market, counterparty, liquidity, operational and Group risk that the UK regulated entities are undertaking.

The Board is closely involved in the ICA process and reviews and approves its assumptions and results.

3.3 Principal risks from insurance activities and use of financial instruments
The Risk management section of the Strategic Report sets out all the risks assessed by the Group as principal risks. Detailed below is the Group's risk exposure arising from its insurance activities and use of financial instruments specifically in respect of insurance risk, market risk and counterparty risk.

3.3.1 Insurance risk
Insurance risk can arise from:

- fluctuations in the timing, frequency and severity of insured events and their ultimate settlement, relative to the expectations of the Group at the time of underwriting, including those driven by inaccurate pricing, inappropriate underwriting guidelines and terms and conditions, and holding inadequate reserves;
- inadequate reinsurance protection; and
- concentration of business leading to unexpected claim levels (frequency and severity) from a single source.

The Group predominantly underwrites personal lines insurance including motor, residential property, roadside assistance, creditor, travel and pet business. The Group also underwrites commercial risks primarily for low-to-medium risk trades within the SME market. Contracts are typically issued on an annual basis, which means that the Group's liability usually extends for a 12-month period, after which the Group is entitled to decline to renew or can impose renewal terms by amending the premium or other policy terms and conditions such as the excess as appropriate.

Prior to July 2011, the Group underwrote long-term insurance falling within the business classes of life and annuity and permanent health. From 6 July 2011 the Group ceased accepting new business. The products provided included mortgage life cover, fixed term cover with critical illness, over 50s life cover and the life cover associated with the creditor business underwritten by the Group's general insurance business. Contracts were issued typically on a long-term basis, which means that the Group's liability extended for a period ranging from five years up to 52 years. On 28 November 2013, the Life business was sold and liability was transferred away from the Group.

For creditor insurance, contracts are issued either on a monthly renewable basis (regular premium), which can be amended or cancelled by the customer at any point during the contract, or cover period of a loan (single premium). In the former case, the Group can cancel or amend the policy following a 90-day written notice period. In the latter case (these policies were withdrawn from sale in April 2009), the customer has the option to cancel the contract at any point but generally the Group is obligated for the full term up to a maximum of 10 years, but typically three to five years.

Reserving risk
Reserving risk relates to both premiums and claims. It is the risk that reserves are assessed incorrectly, such that either insufficient funds have been retained to pay or handle claims as the amounts fall due both in relation to those claims which have already been incurred (in relation to claims reserves) or will be incurred in future periods of insurance (in relation to premium reserves), or a surplus of funds has been retained resulting in opportunity costs.

3. Risk management continued

Reserving risk is controlled through a range of processes:

- regular periodic reviews of the claims, premium and liability adequacy reserves for the main classes of business by the internal actuarial team;
- the use of external actuaries to review periodically the actuarial best estimate reserves produced internally, either through peer review or through provision of independent reserve estimates;
- accompanying all reserve reviews with actuarial assessment of the uncertainties through a variety of techniques including bootstrapping and scenario analysis;
- oversight of the reserving process by relevant senior management and the Board;
- regular reconciliation of the data used in the actuarial reviews against general ledger data and reconciliation of the claims data history against the equivalent data from prior reviews; and
- assessing the volatility in the reserves to help the Board set management best estimate reserves.

The Group's reserves are particularly susceptible to potential retrospective changes in legislation and new court decisions, for example, a change in the Ogden discount rate. This is the discount rate set by the relevant government bodies and used by courts to calculate lump sum awards in bodily injury cases. The rate is currently 2.5% per annum but is under review by the MoJ. From 2010, the Group has calculated its estimated reserve based on an assumed Ogden discount rate of 1.5%, in recognition of the uncertainty regarding the future rate.

As referred to on page 25, uncertainty in claims reserve estimation is larger for claims such as PPOs for which annually indexed payments are made periodically over several years or even the lifetime of the injured party. Claims reserves for PPOs are held on a discounted basis and the table below indicates the sensitivity of discounted claims reserves to changes in the discount rate.

The table below provides a sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table and above could have an additional financial impact on the Group.

	Increase / (decrease) in income statement		Increase / (decrease) in total equity at 31 December	
	2013 £m	2012 £m	**2013 £m**	2012 £m
PPOs[1]				
Impact of an increase in the discount rate used in the calculation of present values of 100 basis points ("bps")	**81.7**	104.7	**80.5**	104.7
Impact of a decrease in the discount rate used in the calculation of present values of 100bps	**(118.5)**	(150.4)	**(116.8)**	(150.4)
Ogden				
Impact of an increase in the Ogden discount rate by 100bps	**169.7**	156.6	**169.7**	156.6
Impact of a decrease in the Ogden discount rate by 100bps	**(238.2)**	(219.8)	**(238.2)**	(219.8)

Notes:

1. The sensitivities relating to an increase or decrease in the discount rate used for PPOs illustrate a movement in the time value of money from the assumed level of 4.0%. An increase in the discount rate reflects a decrease in the time value of money and therefore the present value of future liabilities which increases the total equity which would be reflected in the income statement.
2. The selection of these sensitivities should not be interpreted as a prediction.
3. The sensitivities set out above include the impact of reinsurance, but exclude the impact of taxation.

Claims management risk

Claims management risk is the risk that claims are paid or handled inappropriately.

Claims are managed utilising a range of IT system driven controls coupled with manual processes outlined in detailed policies and procedures to ensure claims are handled in an appropriate, timely and accurate manner.

Each member of staff has a specified handling authority, with controls preventing them handling or paying claims outside their authority, as well as controls to mitigate the risk of paying invalid claims. In addition, there are various outsourced claims handling arrangements, all of which are monitored closely by management, with similar principles applying in terms of the controls and procedures.

Loss adjustors are used in certain circumstances to handle claims to conclusion. This involves liaison with the policyholder, third parties, suppliers and the claims function.

Specialist bodily injury claims teams in the UK are responsible for handling these types of losses with the nature of handling dependent on the level and type of claim. Where applicable, they are referred to the technical and large loss teams who also deal with all other claim types above defined limits or within specific criteria.

A process is in place in the UK business to deal with major weather and other catastrophic events, known as the 'Surge Demand Plan'. A surge is the collective name given to an incident which significantly increases the volume of claims reported to the Group's claims functions. The plan covers surge demand triggers, stages of incident, operational impact, communication and management information monitoring of the impact.

Reinsurance risk

The Group uses reinsurance to:

- protect the insurance results against low-frequency, high-severity losses through the transfer of catastrophe claims volatility to reinsurers;
- protect the insurance results against unforeseen volumes of, or adverse trends in, large individual claims in order to reduce volatility and to improve stability of earnings;
- reduce the Group's capital requirements; and / or
- transfer risk that is not within the Group's current risk retention strategy.

Using reinsurance the Group cedes insurance risk to reinsurers but, in return, assumes back counterparty risk against which a reinsurance bad debt provision is assessed. The financial security of the Group's panel of reinsurers is therefore extremely important and both the quality and quantum of the assumed counterparty risk are subject to an approval process whereby reinsurance is only purchased from reinsurers that hold a credit rating of at least A- at the time cover is purchased. The Group's leading counterparty exposures represent the accumulated counterparty risk for all Group underwriting entities and are reviewed on a monthly basis. The Group aims to contract with a diverse range of reinsurers on its contracts to mitigate the credit and / or non-payment risks associated with its reinsurance exposures.

Certain reinsurance contracts have long durations as a result of PPOs, and insurance reserves therefore include provisions beyond the levels created for shorter-term reinsurance bad debt.

Reinsurance risk arises from:

- a failure of reinsurance to control exposure to losses, to reduce volatility or to protect capital;
- an inability to place reinsurance cost effectively or on acceptable terms; and / or
- reinsurer defaults.

Insurance concentration risk

The Group is subject to concentration risk in a variety of forms, including:

- geographic concentration risk – the Group purchases a UK catastrophe reinsurance programme to protect against a modelled 1 in 200 year loss. The retained deductible is £150 million at 31 December 2013 (2012: £125 million). There are also relevant covers to protect the Group's international businesses;
- product concentration risk – the Group's business is heavily concentrated in the UK general insurance market. However, the Group offers a diversified portfolio of products and a variety of brands sold through a range of distribution channels to its customers;
- sector concentration risk – the concentration of the Group to any given industry sector is monitored and analysed in respect of commercial customers; and
- reinsurance concentration risk – reinsurance is purchased from a number of providers to ensure that a diverse range of counterparties is contracted with, within the desired credit rating range.

3.3.2 Financial risk

The Group is exposed to financial risk through its financial assets and financial liabilities. The Group's financial risk is concentrated within its investment portfolio and reinsurance.

The strategic asset allocation within the investment portfolio is agreed by the Investment Committee. The Investment Committee determines policy and controls, covering such areas as safety, liquidity and performance. The Investment Committee meets at least three times a year to evaluate risk exposure, the current strategy, associated policies and investment guidelines and to consider investment recommendations submitted to it. Oversight of the implementation of decisions taken by the Investment Committee is via various risk fora.

3. Risk management continued

The investment management objectives are:

- to maintain the safety of the portfolio's principal both in economic terms and from a capital, accounting and reporting perspective;
- to maintain sufficient liquidity to provide cash requirements for operations, including in the event of a catastrophe; and
- to maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the investment guidelines and capital allocation.

3.3.2.1 Market risk

Market risk is the risk associated with the adverse impact of the market risk factors' movement on the Group's balance sheet due to changes in the fair value or cash flows of its assets or liabilities.

The Group is mainly exposed to the following market risk factors:

- interest rate risk;
- spread risk;
- foreign currency risk; and
- property risk.

The Group has policies and limits approved by the Board for managing the market risk exposure. These set out the principles that the business should adhere to for managing market risk and establishing the maximum limits the Group is willing to accept having considered strategy, risk appetite and capital resources.

The Group monitors its market risk exposure on a monthly basis and has established an aggregate exposure limit consistent with its risk objective to maintain capital adequacy. Interdependencies across risk types have also been considered within the aggregate exposure limit. The allocation of the Group's investments across asset classes has been approved at the Investment Committee.

The Group uses its internal capital model to determine its capital requirements and market risk limits, and monitors its market risk exposure based on a 99.5% one-year value at risk measure. The Group also applies market risk stressed scenarios testing for analysing the economic impact of specific severe market conditions. The results of this analysis are used to enhance the understanding of market risk. The market risk policy explicitly prohibits the use of derivatives for speculative or gearing purposes, however the Group is able to, and does, use derivatives for hedging its currency risk and interest rate risk exposures.

Interest rate risk

The Group's interest rate risk arises mainly from its debt, floating interest rate investments and assets and liabilities exposed to fixed interest rates.

In 2012, the Group issued £500 million of subordinated debt with a 30-year maturity and fixed rate coupon for the first 10 years. The cost of the fixed rate coupon has been hedged down to the three-month London Interbank Offered Rate ("**LIBOR**") floating rate.

The Group also invests in floating rate notes, whose investment income is influenced by the movement of the short-term interest rate. A movement of the short-term interest rate will affect the expected return on the investments.

The market value of the Group's investments in fixed coupon securities is affected by the movement of the interest rates. For the investments in US Dollar corporate bonds, the Group hedges the exposure of this portfolio to the US Dollar interest rate risk using swaps. The derivatives reduce the duration of the portfolio to close to zero, eliminating its sensitivity to the US Dollar interest rate fluctuation.

Spread risk

Spread risk represents the risk of adverse fluctuation of the value of assets due to changes in the level of spreads. The level of spread is the difference between the risk free rate and actual rate paid on the asset, with larger spreads being associated with higher risk assets. The Group is exposed to spread risk through its investments in investment grade bonds and securitised credit.

Foreign currency risk

The exposure to currency risk is generated by the Group's investments in US Dollar corporate bonds, US Dollar securitised credit and its investment in subsidiaries.

At 31 December 2013, the Group maintained exposure to US Dollar securities through its investments in US Dollar corporate bonds and US Dollar securitised credits. The foreign currency exposure of these investments is hedged by foreign currency forward contracts, maintaining a minimal unhedged (direct) currency exposure on these portfolios, as well as a low basis currency risk on the hedging.

The Group is also exposed to currency risk through its investments in subsidiaries in Italy and Germany (that is, investments in equity). In September 2013, the Group changed its currency hedging strategy on these investments to accept the long-term foreign exchange fluctuation impact on its investment in subsidiaries.

Property risk

Property risk results from adverse price fluctuations on real estate investments. At 31 December 2013, the value of these investments in property was £223.4 million (2012: £128.9 million). The property investments are located in the UK and are subject to the asset admissibility rules as defined by the PRA.

The table below provides a sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group.

	Increase / (decrease) in income statement		Increase / (decrease) in total equity at 31 December	
	2013 £m	2012 £m	**2013 £m**	2012 £m
Spread				
Impact of an increase in AFS debt securities of 100bps movement in spreads[1]	**–**	–	**(187.8)**	(155.3)
Interest rate				
Impact on AFS debt securities of an increase in interest rate of 100bps[1,2]	**18.0**	12.9	**(170.5)**	(168.6)
Investment property				
Impact of a decrease in property markets of 15%	**(33.5)**	(19.3)	**(33.5)**	(19.3)

Notes:

1. The income statement impact on AFS debt securities is limited to floating rate bonds and interest rate derivatives used to hedge a portion of the portfolio. The income statement is not impacted in relation to fixed rate bonds, where the coupon return is not impacted by a change in prevailing market rates, as the accounting treatment for AFS debt securities means that only the coupon received is processed through the income statement with fair value movements being recognised through total equity.
2. The sensitivities set out above reflect one-off impacts at 31 December with the exception of the income statement interest rate sensitivity on AFS debt securities, which projects a movement in a full year's interest charge as a result of the increase in the interest rate applied to the AFS debt securities and interest rate hedges on those positions held at 31 December.
3. The subordinated debt is excluded from the sensitivity analysis.
4. The selection of these sensitivities should not be interpreted as a prediction.
5. The sensitivities set out above have not considered the impact of the general market changes on the value of the Group's insurance contract liabilities or retirement benefit obligations.
6. The sensitivities set out above exclude the impact of taxation.

3. Risk management continued

The tables below analyse the maturity of the Group's derivative assets and liabilities.

At 31 December 2013	Notional amounts	Maturity and fair value			
	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**1,315.8**	23.8	–	–	**23.8**
Interest rate swaps	**370.1**	(1.0)	1.7	8.9	**9.6**
Interest rate futures	**561.3**	7.3	–	–	**7.3**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**–**	–	–	–	**–**
Total	**2,247.2**	**30.1**	**1.7**	**8.9**	**40.7**

At 31 December 2013	Notional amounts	Maturity and fair value			
	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**–**	–	–	–	**–**
Interest rate swaps	**739.9**	(1.1)	0.4	18.5	**17.8**
Interest rate futures	**–**	–	–	–	**–**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**9.6**	0.8	0.7	–	**1.5**
Total	**749.5**	**(0.3)**	**1.1**	**18.5**	**19.3**

At 31 December 2012	Notional amounts	Maturity and fair value			
	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	1,339.7	11.9	–	–	11.9
Interest rate swaps	505.5	1.7	–	23.7	25.4
Interest rate futures	121.5	–	0.1	0.1	0.2
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	1.2	–	–	–	–
Total	1,967.9	13.6	0.1	23.8	37.5

At 31 December 2012	Notional amounts	Maturity and fair value			
	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	666.5	0.2	–	–	0.2
Interest rate swaps	468.7	–	3.1	0.7	3.8
Interest rate futures	375.7	–	0.1	–	0.1
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	228.2	2.4	–	–	2.4
Total	1,739.1	2.6	3.2	0.7	6.5

The Group has a number of open interest rate and foreign exchange derivative positions. Collateral management arrangements are in place for significant counterparty exposures. At 31 December 2013, £4.9 million (2012: £4.6 million) in cash and a £20.0 million (2012: £nil) UK Gilt have been pledged by the Group to cover out of the money derivative positions. £18.0 million (2012: £0.8 million) in cash and £nil (2012: £1.1 million) US Treasury bonds have been pledged to the Group to cover in the money derivative positions.

The terms and conditions of collateral pledged for both assets and liabilities are market standard. When securities are pledged they are required to be readily convertible to cash, and as such there has been no policy established for the disposal of assets not readily convertible into cash.

3.3.2.2 Counterparty risk

Counterparty risk arises from the potential that losses are incurred from the failure of counterparties to meet their credit obligations, due to either their failure and / or their inability to pay or their unwillingness to pay amounts due.

Counterparty risk is primarily managed through the Credit Risk and Investment Forum. The main responsibility of this forum is to ensure that all material aspects of counterparty risk within the Group are identified, monitored and measured.

The main sources of counterparty risk for the Group are:

- investment counterparty – this arises from the investment of monies in the range of investment vehicles permitted by the investment policy; and
- reinsurance recoveries – counterparty exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed. The Courts Act 2003, implemented in April 2005, gave the courts the power to award PPOs in place of lump sum awards to cover the future costs element of claims (that is, loss of future earnings and / or cost of future care). PPOs have the potential to increase the ultimate value of a claim and, by their very nature, to significantly increase the length of time to reach final payment. This has increased reinsurance counterparty risk in terms of both quantum and longevity.

The tables below analyse the carrying value of financial and insurance assets that bear counterparty risk between those assets that have not been impaired, by age in relation to due date, and those that have been impaired.

At 31 December 2013	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
AFS debt securities	**7,001.2**	–	–	4.3	**7,005.5**
Deposits with credit institutions	**1,036.5**	–	–	–	**1,036.5**
Reinsurance assets	**1,011.0**	–	–	–	**1,011.0**
Derivative assets	**40.7**	–	–	–	**40.7**
Cash at bank and in hand	**307.5**	–	–	–	**307.5**
Insurance and other receivables	**1,075.8**	42.8	3.4	–	**1,122.0**
Total	**10,472.7**	**42.8**	**3.4**	**4.3**	**10,523.2**

At 31 December 2012	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
AFS debt securities	7,147.9	–	–	8.6	7,156.5
Deposits with credit institutions	1,951.7	–	–	–	1,951.7
Reinsurance assets	1,102.0	–	–	–	1,102.0
Derivative assets	37.5	–	–	–	37.5
Cash at bank and in hand	201.7	–	–	–	201.7
Insurance and other receivables	1,109.8	50.3	3.9	–	1,164.0
Total	11,550.6	50.3	3.9	8.6	11,613.4

There were no material financial assets that would have been past due or considered for impairment had the contractual terms not been renegotiated.

Within the analysis of AFS debt securities above are bank debt securities at 31 December 2013 of £1,625.2 million (2012: £1,510.8 million), that can be further analysed as: secured £135.9 million (2012: £211.1 million); unsecured £1,297.4 million (2012: £1,153.4 million); and subordinated £191.9 million (2012: £146.3 million).

3. Risk management continued

The tables below analyse the credit quality of AFS debt securities that are neither past due nor impaired.

At 31 December 2013	AAA £m	AA+ to AA- £m	A+ to A- £m	BBB+ to BBB- £m	BB+ and below £m	Total £m
Corporate	321.3	695.6	2,722.7	1,134.2	–	**4,873.8**
Supranational	317.3	48.4	–	–	–	**365.7**
Local government	75.7	44.0	14.8	–	–	**134.5**
Sovereign	4.3	1,369.0	–	26.2	–	**1,399.5**
Securitised credit[1]	193.4	22.1	8.4	–	3.8	**227.7**
Total	**912.0**	**2,179.1**	**2,745.9**	**1,160.4**	**3.8**	**7,001.2**

At 31 December 2012	AAA £m	AA+ to AA- £m	A+ to A- £m	BBB+ to BBB- £m	BB+ and below £m	Total £m
Corporate	497.6	748.4	2,534.3	680.8	5.9	4,467.0
Supranational	447.0	74.8	–	–	–	521.8
Local government	127.8	110.5	15.6	17.2	–	271.1
Sovereign	1,831.2	11.6	–	–	–	1,842.8
Securitised credit[1]	24.8	–	16.7	–	3.7	45.2
Total	2,928.4	945.3	2,566.6	698.0	9.6	7,147.9

Note:

1. Securitised credit is all in the form of prime mortgage backed securities, collateralised loan obligations, securitised student loans and commercial mortgage backed securities.

The tables below analyse the credit quality of financial and insurance assets that are neither past due nor impaired (excluding AFS debt securities analysed above). The table includes reinsurance exposure, after provision. Note 3.3.1 details the Group's approach to reinsurance counterparty risk management.

At 31 December 2013	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB- £m	BB+ and below £m	Not rated £m	Total £m
Deposits with credit institutions	545.8	60.0	430.7	–	–	–	**1,036.5**
Reinsurance assets	0.3	710.9	289.0	0.7	–	10.1	**1,011.0**
Derivative assets	–	5.7	35.0	–	–	–	**40.7**
Cash at bank and in hand	–	0.2	255.4	51.7	–	0.2	**307.5**
Insurance and other receivables[1]	–	9.2	25.7	2.4	–	1,038.5	**1,075.8**
Total	**546.1**	**786.0**	**1,035.8**	**54.8**	**-**	**1,048.8**	**3,471.5**

At 31 December 2012	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB- £m	BB+ and below £m	Not rated £m	Total £m
Deposits with credit institutions	1,256.7	145.0	550.0	–	–	–	1,951.7
Reinsurance assets	–	747.9	339.0	4.6	–	10.5	1,102.0
Derivative assets	–	2.5	35.0	–	–	–	37.5
Cash at bank and in hand	–	–	193.2	4.2	4.3	–	201.7
Insurance and other receivables[1]	–	10.7	88.7	1.0	1.3	1,008.1	1,109.8
Total	1,256.7	906.1	1,205.9	9.8	5.6	1,018.6	4,402.7

Note:

1. Other loans and receivables due from policyholders, agents, brokers and intermediaries generally do not have a credit rating.

Liquidity risk

Liquidity risk is the potential that obligations cannot be met as they fall due as a consequence of having a timing mismatch and / or an inability to raise sufficient liquid assets or cash without suffering a substantial loss on realisation.

The measurement and management of liquidity risk within the Group is undertaken within the limits and other policy parameters of the Group's liquidity risk appetite and is detailed within the liquidity risk policy and supporting minimum standards. Compliance is monitored in respect of both the internal policy and the regulatory requirements of local regulators.

In the event that one or more liquidity stresses or scenarios crystallises, or should any other event that may impact liquidity occur, the Group ensures a rapid and controlled response to the event. In such an event, a liquidity crisis management team will be formed to assess the nature and extent of the threat and to develop an appropriate response.

The table below analyses AFS debt securities by maturity.

At 31 December	**2013 £m**	2012 £m
Within 1 year	**1,018.4**	760.1
1 – 3 years	**1,953.0**	3,088.5
3 – 5 years	**1,920.9**	2,026.5
5 – 10 years	**1,794.9**	1,152.3
Over 10 years	**318.3**	129.1
Total	**7,005.5**	7,156.5

In addition to the above, the Group held cash and cash equivalents at 31 December 2013 of £908.3 million (2012: £1,508.4 million) to cover short-term liabilities arising from insurance contracts.

The tables below analyse insurance and financial liabilities by remaining duration, in proportion to the cash flows expected to arise during that period, for each category.

At 31 December 2013	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	**486.6**	8.2	–	–	478.4	–
Insurance liabilities	**5,757.4**	1,817.3	1,469.9	687.1	630.9	1,152.2
Borrowings	**55.1**	55.1	–	–	–	–
Trade and other payables including insurance payables	**818.3**	794.3	6.4	1.9	6.4	9.3
Total	**7,117.4**	**2,674.9**	**1,476.3**	**689.0**	**1,115.7**	**1,161.5**

At 31 December 2012	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	787.5	266.7	–	–	520.8	–
Insurance liabilities	6,398.5	1,872.6	1,749.9	857.9	785.5	1,132.6
Borrowings	90.9	90.9	–	–	–	–
Trade and other payables including insurance payables	654.6	648.7	2.1	0.6	3.2	–
Total	7,931.5	2,878.9	1,752.0	858.5	1,309.5	1,132.6

The above tables exclude unearned premium reserves as there are no liquidity risks inherent in them.

3. Risk management continued

Concentration risk

Concentration risk on investments arises through excessive exposure to particular industry sectors, groups of business undertakings or similar activities. The Group may suffer significant losses in its investment portfolio as a result of over-exposure to particular sectors engaged in similar activities or similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions.

The table below analyses the distribution of AFS debt securities by geographical area.

At 31 December 2013	Corporate £m	Supranational £m	Local government £m	Sovereign £m	Securitised credit £m	Total £m
Australia	249.8	–	–	–	–	**249.8**
Belgium	48.7	–	–	4.4	–	**53.1**
Brazil	2.9	–	–	1.4	–	**4.3**
Canada	59.2	–	52.2	–	–	**111.4**
China	1.7	–	–	–	–	**1.7**
Czech Republic	6.3	–	–	–	–	**6.3**
Denmark	38.2	–	–	–	–	**38.2**
Finland	13.3	–	–	–	–	**13.3**
France	364.9	–	8.1	1.8	8.4	**383.2**
Germany	407.3	–	24.3	–	33.5	**465.1**
Hong Kong	8.5	–	–	–	–	**8.5**
Ireland	0.3	–	–	–	3.8	**4.1**
Italy	49.3	–	–	20.4	–	**69.7**
Japan	44.5	–	–	–	–	**44.5**
Mexico	10.8	–	–	3.0	–	**13.8**
Netherlands	227.3	–	–	4.3	–	**231.6**
New Zealand	24.0	–	–	–	–	**24.0**
Norway	36.4	–	24.9	–	–	**61.3**
Russia	5.3	–	–	–	–	**5.3**
Singapore	24.4	–	–	–	–	**24.4**
South Africa	–	–	–	1.4	–	**1.4**
South Korea	7.1	–	–	–	–	**7.1**
Spain	31.2	–	–	–	–	**31.2**
Sweden	150.0	–	19.1	–	–	**169.1**
Switzerland	118.5	–	–	–	–	**118.5**
UAE	6.6	–	–	–	–	**6.6**
UK	1,671.4	–	–	1,362.8	35.1	**3,069.3**
USA	1,270.2	–	5.9	–	146.9	**1,423.0**
Multilateral / supranational	–	365.7	–	–	–	**365.7**
Total	**4,878.1**	**365.7**	**134.5**	**1,399.5**	**227.7**	**7,005.5**

The table below analyses the distribution of AFS debt securities by geographical area.

At 31 December 2012	Corporate £m	Supranational £m	Local government £m	Sovereign £m	Securitised credit £m	Total £m
Australia	239.0	–	–	–	–	239.0
Austria	–	–	–	2.9	–	2.9
Belgium	16.0	–	–	7.1	–	23.1
Brazil	0.4	–	–	–	–	0.4
Canada	69.4	–	134.6	–	–	204.0
Cayman Islands	7.5	–	–	–	–	7.5
Czech Republic	6.4	–	–	–	–	6.4
Denmark	32.5	–	–	–	–	32.5
Finland	13.3	–	–	–	–	13.3
France	291.7	–	–	4.5	8.4	304.6
Germany	359.6	–	–	–	33.1	392.7
Hong Kong	3.3	–	–	–	–	3.3
Ireland	13.9	–	–	–	3.7	17.6
Israel	4.4	–	–	–	–	4.4
Italy	36.4	–	–	–	–	36.4
Japan	65.7	–	–	–	–	65.7
Mexico	5.8	–	17.2	–	–	23.0
Netherlands	119.0	–	–	4.3	–	123.3
New Zealand	40.3	–	–	–	–	40.3
Norway	22.4	–	82.2	–	–	104.6
Singapore	25.5	–	–	–	–	25.5
South Korea	7.4	–	–	–	–	7.4
Spain	16.3	–	–	–	–	16.3
Sweden	200.7	–	31.0	–	–	231.7
Switzerland	108.5	–	–	–	–	108.5
UAE	12.2	–	–	–	–	12.2
UK	1,772.6	–	–	1,824.0	–	3,596.6
USA	985.4	–	6.1	–	–	991.5
Multilateral / supranational	–	521.8	–	–	–	521.8
Total	4,475.6	521.8	271.1	1,842.8	45.2	7,156.5

3. Risk management continued

The table below analyses the distribution of AFS debt securities by industry sector classifications.

	2013		2012	
At 31 December	£m	%	£m	%
Basic materials	**196.5**	**3%**	199.7	3%
Communications	**394.1**	**6%**	333.7	5%
Consumer, cyclical	**192.9**	**3%**	137.2	2%
Consumer, non-cyclical	**451.0**	**6%**	475.7	6%
Diversified	**82.3**	**1%**	120.9	2%
Energy	**249.9**	**4%**	273.8	4%
Financial	**2,163.3**	**31%**	1,798.3	25%
Industrial	**274.9**	**4%**	265.1	4%
Mortgage and other asset backed securities	**227.7**	**3%**	45.2	0%
Sovereign, supranational and local government	**1,899.7**	**27%**	2,635.7	37%
Technology	**51.5**	**1%**	59.9	1%
Transport	**18.0**	**0%**	18.1	0%
Utilities	**803.7**	**11%**	793.2	11%
Total	**7,005.5**	**100%**	7,156.5	100%

3.4 Capital adequacy

The Group defines its capital requirement in accordance with the regulations prescribed by the PRA, other regulatory bodies and the credit rating agencies. Capital is managed in accordance with the Group's capital management minimum standard, the objectives of which are to manage capital efficiently and maintain an appropriate level of capitalisation and solvency.

The Group determines the appropriate level of capital on the basis of a number of criteria, including its risk-based capital requirement, the maintenance of a prudent excess capital over its regulatory capital requirements and its rating agency capital. The Group also seeks to hold capital coverage in the range of 125% to 150% of its risk-based capital requirement which is consistent with an 'A' range credit rating.

The UK regulated insurance entities of the Group carry out an assessment of the adequacy of their overall financial resources in accordance with the PRA's ICA methodology. The Group also monitors its financial resources with reference to the requirements of the IGD. The UK capital requirement is calculated based on an internal risk based capital model which is calibrated, as required by the PRA, to a 99.5% confidence interval over a one-year time horizon. The risk-based capital model also supports decision making in the business.

The capital for European entities is maintained in accordance with the local regulatory solvency requirements. The Group manages its subsidiaries on an ongoing basis to ensure that capital resources exceed regulatory minima in accordance with its risk appetite.

The Group has an IGD surplus at 31 December 2013 of approximately £1.8 billion (2012: £1.8 billion).

The Group's capital requirements and solvency position are produced and presented to the Board on a regular basis.

4. Segmental analysis

The Directors manage the Group primarily by product type and present the segmental analysis on that basis. The segments reflect the management structure whereby a member of the Executive Committee is accountable to the Chief Executive Officer for each of the following operating segments:

Motor

This segment consists of personal car insurance cover together with the associated legal expenses business. The Group sells motor insurance through its own brands – Direct Line, Churchill and Privilege – and through partnership brands directly to customers or through PCWs. As a result, the Group has a brand and product offering that covers most major retail customer segments for motor insurance in the UK.

Home

This segment consists of the underwriting of home insurance together with associated legal expenses cover. The Group sells home insurance through its own brands – Direct Line, Churchill and Privilege – and through partnerships or PCWs. The Group's brand and product offering covers most of the major retail customer segments for home insurance in the UK.

Rescue and other personal lines

This segment consists of the underwriting of rescue and recovery insurance products and other personal lines business, including travel, pet, life (conducted by Direct Line Life Insurance Company Limited which was sold on 28 November 2013) and creditor.

The Group sells rescue and recovery insurance as a stand-alone product through the Green Flag brand or as an insurance add-on to all Group own brand and certain partner motor policies, or as part of packaged bank accounts sold through our bank partnership channel. Rescue insurance policies range from basic roadside rescue to a full Europe-wide breakdown recovery service.

The Group sells its other personal lines insurance through its own brands – Direct Line, Churchill and Privilege – and through partnerships.

Commercial

This segment consists of the underwriting of commercial insurance for micro businesses and SMEs in the UK. The Group sells commercial products through its own brands – NIG and Direct Line for Business – and through its partnership with RBS and NatWest.

International

This segment consists primarily of personal motor car insurance cover sold in Italy and Germany using a multi-channel strategy through the Direct Line brand and through partnerships and PCWs.

Certain income and charges are not allocated to the specific operating segments above as they are considered by management to be outside underlying business activities by virtue of their one-off incidence, size or nature. Such income and charges are categorised as either run-off, described below, or restructuring and other one-off costs.

Run-off

The segment consists of two principal lines, policies previously written through the personal lines broker channel and Tesco business. These residual businesses are now in run-off.

No inter-segment transactions occurred in the year ended 31 December 2013 (2012: £nil). If any transaction were to occur, transfer prices between operating segments would be set on an arm's length basis in a manner similar to transactions with third parties. Segment income, expenses and results will include those transfers between business segments which will then be eliminated on consolidation.

For each operating segment, there is no individual policyholder or customer that represents 10% or more of the Group's total revenue.

4. Segmental analysis continued

The table below is an analysis of the Group's revenue and results by reportable segment in the year ended 31 December 2013:

	Motor £m	Home £m	Rescue and other personal lines[1] £m	Commercial £m	International £m	Total ongoing £m	Run-off[1] £m	Total £m
Gross written premium	1,421.1	943.1	383.4	474.5	604.5	**3,826.6**	7.9	**3,834.5**
Gross earned premium	1,498.4	958.9	383.1	468.7	579.3	**3,888.4**	7.9	**3,896.3**
Reinsurance premium ceded	(53.6)	(50.0)	(17.3)	(34.1)	(212.8)	**(367.8)**	(5.2)	**(373.0)**
Net earned premium	1,444.8	908.9	365.8	434.6	366.5	**3,520.6**	2.7	**3,523.3**
Investment return	122.8	24.1	8.2	29.6	23.4	**208.1**	13.0	**221.1**
Instalment income	78.3	25.2	1.3	6.2	6.8	**117.8**	–	**117.8**
Other operating income	48.5	0.7	9.1	3.3	0.8	**62.4**	–	**62.4**
Total income	1,694.4	958.9	384.4	473.7	397.5	**3,908.9**	15.7	**3,924.6**
Insurance claims	(978.3)	(476.7)	(240.0)	(274.8)	(453.0)	**(2,422.8)**	88.0	**(2,334.8)**
Insurance claims recoverable from reinsurers	38.1	(13.7)	20.2	4.2	169.6	**218.4**	(37.9)	**180.5**
Net insurance claims	(940.2)	(490.4)	(219.8)	(270.6)	(283.4)	**(2,204.4)**	50.1	**(2,154.3)**
Commission expenses	(36.3)	(177.9)	(27.3)	(92.2)	(57.9)	**(391.6)**	(0.8)	**(392.4)**
Operating expenses	(370.2)	(184.4)	(90.8)	(101.4)	(39.6)	**(786.4)**	(1.4)	**(787.8)**
Total expenses	(406.5)	(362.3)	(118.1)	(193.6)	(97.5)	**(1,178.0)**	(2.2)	**(1,180.2)**
Operating profit before restructuring and other one-off costs	**347.7**	**106.2**	**46.5**	**9.5**	**16.6**	**526.5**	**63.6**	**590.1**
Restructuring and other one-off costs[2]								**(140.5)**
Operating profit								**449.6**
Finance costs								**(37.7)**
Gain on disposal of subsidiary								**12.0**
Profit before tax								**423.9**
Underwriting profit / (loss)	**98.1**	**56.2**	**27.9**	**(29.6)**	**(14.4)**	**138.2**		
Loss ratio	65.1%	53.9%	60.1%	62.3%	77.3%	**62.6%**		
Commission ratio	2.5%	19.6%	7.5%	21.2%	15.8%	**11.2%**		
Expense ratio	25.6%	20.3%	24.8%	23.3%	10.8%	**22.3%**		
Combined operating ratio	**93.2%**	**93.8%**	**92.4%**	**106.8%**	**103.9%**	**96.1%**		

Notes:

1. The Group's revenue and results for the year ended 2013 relating to the Life business which was disposed of on 28 November 2013 was recorded in two segments: Rescue and other personal lines (net earned premium: £11.8 million, net insurance claims: £1.8 million and operating profit: £6.4 million) and Run-off (net earned premium: £2.8 million, net insurance claims: £0.7 million and operating profit: £1.2 million).
2. Restructuring costs are costs which have been incurred in respect of business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs which are non-recurring in nature.

The table below is an analysis of the Group's revenue and results by reportable segment in the year ended 31 December 2012:

	Motor £m	Home £m	Rescue and other personal lines[1] £m	Commercial £m	International £m	Total ongoing £m	Run-off[1] £m	Total £m
Gross written premium	1,623.5	989.0	389.8	435.6	552.7	3,990.6	10.8	4,001.4
Gross earned premium	1,677.8	1,005.2	402.5	433.2	510.3	4,029.0	19.5	4,048.5
Reinsurance premium ceded	(48.6)	(54.4)	(19.7)	(30.4)	(167.2)	(320.3)	(6.2)	(326.5)
Net earned premium	1,629.2	950.8	382.8	402.8	343.1	3,708.7	13.3	3,722.0
Investment return	140.0	34.1	7.5	29.4	23.7	234.7	47.1	281.8
Instalment income	88.4	25.9	1.2	3.5	6.4	125.4	–	125.4
Other operating income	59.7	0.6	9.5	2.4	0.7	72.9	0.4	73.3
Total income	1,917.3	1,011.4	401.0	438.1	373.9	4,141.7	60.8	4,202.5
Insurance claims	(1,364.8)	(560.7)	(218.1)	(278.2)	(401.9)	(2,823.7)	(51.6)	(2,875.3)
Insurance claims recoverable from reinsurers	148.3	6.0	23.2	24.1	133.9	335.5	115.5	451.0
Net insurance claims	(1,216.5)	(554.7)	(194.9)	(254.1)	(268.0)	(2,488.2)	63.9	(2,424.3)
Commission expenses	(31.9)	(154.2)	(22.9)	(87.0)	(41.5)	(337.5)	(115.4)	(452.9)
Operating expenses	(407.1)	(209.2)	(98.8)	(94.8)	(44.9)	(854.8)	(3.2)	(858.0)
Total expenses	(439.0)	(363.4)	(121.7)	(181.8)	(86.4)	(1,192.3)	(118.6)	(1,310.9)
Operating profit before restructuring and other one-off costs	261.8	93.3	84.4	2.2	19.5	461.2	6.1	467.3
Restructuring and other one-off costs[2]								(189.5)
Operating profit								277.8
Finance costs								(28.7)
Profit before tax								249.1
Underwriting (loss) / profit	(26.3)	32.7	66.2	(33.1)	(11.3)	28.2		
Loss ratio	74.6%	58.4%	50.9%	63.1%	78.1%	67.1%		
Commission ratio	2.0%	16.2%	6.0%	21.6%	12.1%	9.1%		
Expense ratio	25.0%	22.0%	25.8%	23.5%	13.1%	23.0%		
Combined operating ratio	101.6%	96.6%	82.7%	108.2%	103.3%	99.2%		

Notes:

1. The Group's revenue and results for the year ended 2012 relating to the Life business which was disposed of on 28 November 2013 was recorded in two segments: Rescue and other personal lines (net earned premium: £18.1 million, net insurance claims: £1.6 million and operating profit: £8.1 million) and Run-off (net earned premium: £3.8 million, net insurance claims: £0.5 million and operating profit: £1.3 million).
2. Restructuring costs are costs which have been incurred in respect of business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs which are non-recurring in nature.

The tables below analyse the Group's assets and liabilities by reportable segment.

At 31 December 2013	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total £m
Goodwill	126.4	45.8	28.7	10.1	–	–	**211.0**
Other segment assets	6,553.0	846.9	164.8	1,447.4	1,298.8	1,265.9	**11,576.8**
Segment liabilities	(4,982.5)	(643.9)	(125.3)	(1,100.5)	(1,068.7)	(1,076.9)	**(8,997.8)**
Reportable segment net assets	**1,696.9**	**248.8**	**68.2**	**357.0**	**230.1**	**189.0**	**2,790.0**

At 31 December 2012	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total £m
Goodwill	126.4	45.8	28.7	10.1	–	–	211.0
Other segment assets	7,146.8	873.1	358.2	1,318.0	1,199.6	1,591.2	12,486.9
Segment liabilities	(5,519.5)	(674.3)	(276.6)	(1,017.9)	(977.5)	(1,400.5)	(9,866.3)
Reportable segment net assets	1,753.7	244.6	110.3	310.2	222.1	190.7	2,831.6

All operations are in the UK except for International which operates in Italy and Germany. The reportable segment net assets do not represent the Group's view of the capital requirements for its operating segments.

5. Net earned premium

	2013 £m	2012 £m
Gross earned premium:		
Gross written premium	**3,834.5**	4,001.4
Movement in unearned premium reserve	**61.8**	47.1
	3,896.3	4,048.5
Reinsurance premium ceded:		
Premium payable	**(368.0)**	(365.4)
Movement in reinsurance unearned premium reserve	**(5.0)**	38.9
	(373.0)	(326.5)
Total	**3,523.3**	3,722.0

6. Investment return

	2013 £m	2012 £m
Investment income:		
Interest income on AFS debt securities	**169.9**	172.5
Other investment funds income	**–**	3.1
Cash and cash equivalent interest income	**7.3**	19.3
Rental income from investment property	**11.4**	4.4
	188.6	199.3
Net realised gains:		
AFS debt securities	**25.7**	66.3
Other investment funds	**–**	23.2
Derivatives	**21.5**	17.8
	47.2	107.3
Net unrealised (losses) /gains:		
Derivatives	**(22.2)**	(20.0)
Investment property (note 18)	**7.5**	(4.8)
	(14.7)	(24.8)
Total	**221.1**	281.8

The table below analyses the realised and unrealised derivatives included in investment return.

	2013		2012	
	Realised £m	Unrealised £m	Realised £m	Unrealised £m
Derivative gains / (losses)				
Foreign exchange forward contracts	**21.2**	**12.0**	24.3	11.7
Associated foreign exchange risk	**2.0**	**(33.3)**	(2.9)	(32.6)
Net gains / (losses) on foreign exchange forward contracts	**23.2**	**(21.3)**	21.4	(20.9)
Interest rate derivatives	**(0.8)**	**19.6**	(3.8)	(2.1)
Associated interest rate risk	**(0.9)**	**(20.5)**	0.2	3.0
Net (losses) / gains on interest rate derivatives	**(1.7)**	**(0.9)**	(3.6)	0.9
Total	**21.5**	**(22.2)**	17.8	(20.0)

7. Other operating income

	2013 £m	2012 £m
Solicitors' referral fee income[1]	**6.9**	21.2
Vehicle replacement referral income	**15.7**	17.5
Revenue from vehicle recovery and repair services	**31.8**	25.9
Fee income from insurance intermediary services	**1.7**	1.9
Other income	**6.3**	6.8
Total	**62.4**	73.3

Note:

1. Following changes to LASPO the payment of referral fees in personal injury cases were prohibited with effect from 1 April 2013.

8. Net insurance claims

	2013		
	Gross £m	Reinsurance £m	Net £m
Current accident year claims paid	**1,306.2**	**(90.5)**	**1,215.7**
Prior accident years claims paid	**1,566.6**	**(75.8)**	**1,490.8**
Movement in insurance liabilities	**(538.0)**	**(14.2)**	**(552.2)**
Total	**2,334.8**	**(180.5)**	**2,154.3**

	2012		
	Gross £m	Reinsurance £m	Net £m
Current accident year claims paid	1,360.0	(71.3)	1,288.7
Prior accident years claims paid	1,612.1	(55.6)	1,556.5
Movement in insurance liabilities	(96.8)	(324.1)	(420.9)
Total	2,875.3	(451.0)	2,424.3

Claims handling expenses for the year ended 31 December 2013 of £246.8 million (2012: £290.3 million) have been included in the claims figures above.

A decrease in the liability adequacy provision for the year ended 31 December 2013 of £4.3 million (2012: £0.7 million increase) has been included in the movement in claims provision.

9. Commission expenses

	2013 £m	2012 £m
Commission expenses	**333.3**	316.5
Expenses incurred under profit participations	**59.1**	136.4
Total[1]	**392.4**	452.9

Note:

1. Includes commission expenses for the Run-off segment for the year ended 31 December 2013 of £0.8 million (2012: £115.4 million).

10. Operating expenses

	2013 £m	2012 £m
Staff costs	**395.3**	416.7
Marketing	**184.2**	203.1
Management fees	**–**	145.5
Depreciation	**21.0**	13.1
Amortisation and impairment of other intangible assets	**37.2**	40.7
Other operating expenses	**290.6**	228.4
Total	**928.3**	1,047.5

Staff costs attributable to claims handling activities are allocated to the cost of insurance claims.

Management fees were in respect of expenses recharged from RBS Group up until 30 June 2012. Management fees were charged on an arm's length basis. From 1 July 2012 the equivalent costs have been incurred directly by the Group and included in staff costs and other operating expenses.

The table below analyses restructuring and other one-off costs included in operating expenses.

	2013 £m	2012 £m
Staff costs[1]	**57.9**	103.9
Management fees	**–**	16.3
Other operating expenses	**82.6**	69.3
Total	**140.5**	189.5

Note:

1. Staff costs include redundancy costs for the year ended 31 December 2013 of £40.9 million (2012: £34.6 million).

The table below analyses the average monthly number of persons employed by the Group.

	2013	2012
Operations	**12,187**	13,662
Support	**1,773**	1,880
Total	**13,960**	15,542

Their aggregate remuneration comprised:

	2013 £m	2012 £m
Wages and salaries	**421.3**	444.5
Social security costs	**49.8**	50.0
Pension costs[1]	**25.8**	62.3
Share-based payments	**4.1**	0.3
Total	**501.0**	557.1

Note:

1. 2012 includes a one-off retirement benefit contribution of £31.3 million in respect of separation from RBS Group (see note 32).

The table below analyses Auditor's remuneration.

	2013 £m	2012 £m
Fees payable for the audit of:		
The Company's annual accounts – Deloitte LLP	**0.4**	0.2
The Company's subsidiaries – Deloitte LLP	**1.6**	1.3
The Company's subsidiaries – Mazars S.p.A	**0.1**	0.1
Total audit fees	**2.1**	1.6
Fees payable to Deloitte LLP for non-audit services:		
Audit-related assurance services	**0.1**	0.3
Taxation advisory services	**–**	0.1
Corporate finance services[1]	**–**	4.1
Total non-audit services	**0.1**	4.5
Total	**2.2**	6.1

Note:

1. Fees incurred for corporate finance services in the year ended 31 December 2012 relate to the divestment of the Group from RBS Group.

Aggregate Directors' emoluments

The table below analyses the total amount of Directors' remuneration in accordance with Schedule 5 to the Accounting Regulations.

	2013 £m	2012 £m
Salaries, fees, bonuses and benefits in kind	**3.2**	2.5
Gains on exercise of share options	**0.5**	0.2
Defined contribution pension scheme contributions	**0.1**	–
Total	**3.8**	2.7

Further information about the remuneration of individual Directors is provided in the Directors' remuneration report.

At 31 December 2013, one Director (2012: one) had retirement benefits accruing under the defined contribution pension scheme in respect of qualifying service.

During the year ended 31 December 2013, two Directors exercised share options (2012: one Director exercised share options) in relation to RBS Group LTIP and incentive deferral plans.

11. Finance costs

	2013 £m	2012 £m
Interest expense on subordinated dated notes[1]	**37.7**	26.7
Other interest expense	**–**	2.0
Total	**37.7**	28.7

Note:

1. As described in note 29, on 27 April 2012 the Group issued subordinated dated notes with a nominal value of £500 million at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year hedge to exchange the fixed rate of interest on the subordinated dated notes for a floating rate of three-month LIBOR plus a spread of 706 bps which increased to 707 bps with effect from 29 July 2013.

12. Tax charge

	2013 £m	2012 £m
Current taxation:		
Charge for the year	**102.5**	61.7
Under / (over) provision in respect of prior year	**1.8**	(1.0)
	104.3	60.7
Deferred taxation (note 13):		
Charge for the year	**1.6**	13.9
Under / (over) provision in respect of prior year	**5.2**	(9.8)
	6.8	4.1
Current taxation	**104.3**	60.7
Deferred taxation (note 13)	**6.8**	4.1
Tax charge for the year	**111.1**	64.8

The following table analyses the difference between the actual income tax charge and the expected income tax charge computed by applying the standard rate of UK corporation tax of 23.25% (2012: 24.5%).

	2013 £m	2012 £m
Profit before tax	**423.9**	249.1
Expected tax charge	**98.6**	61.0
Effects of:		
Higher tax rates on overseas earnings	**0.7**	3.0
Realised gains on disposal of subsidiary	**(2.8)**	–
Re-measurement of deferred tax asset	**3.7**	–
Disallowable expenses	**4.7**	9.6
Non-taxable items	**(0.5)**	(0.7)
Effect of change in UK taxation rate	**(0.3)**	2.7
Under / (over) provision in respect of prior year	**7.0**	(10.8)
Tax charge for the year	**111.1**	64.8
Effective income tax rate	**26.2%**	26.0%

Note:

1. The UK Government enacted a reduction in the UK corporation tax rate from 24% to 23% effective from 1 April 2013 in the Finance Act 2012 and in the Finance Act 2013 enacted further reductions to 21% effective from 1 April 2014 and 20% effective from 1 April 2015. As a consequence the closing deferred tax assets and liabilities have been recognised at the tax rates expected to apply when the assets or liabilities are settled. The impact of these changes on the tax charge for the year is set out in the table above.

.	2013 £m	2012 £m
Per balance sheet:		
Current tax assets	**1.3**	5.5
Current tax liabilities	**(21.1)**	(34.5)

13. Deferred tax

The table below analyses the major deferred tax assets and liabilities recognised by the Group and movements thereon.

	Provisions and other temporary differences[2] £m	Retirement benefit obligations £m	Depreciation in excess of capital allowances £m	Non-distributable reserve £m	Investment properties[1] £m	Share based payments £m	Total £m
At 1 January 2012	22.5	(0.6)	0.9	(8.0)	–	–	14.8
Credit / (charge) to income statement	5.2	(0.6)	(0.5)	(7.4)	–	(0.8)	(4.1)
(Charge) / credit to other comprehensive income	(6.1)	0.6	–	–	–	–	(5.5)
Other movements	(3.6)	–	–	–	–	–	(3.6)
At 31 December 2012	18.0	(0.6)	0.4	(15.4)	–	(0.8)	1.6
(Charge) / credit to income statement	**(4.5)**	**(0.5)**	**0.7**	**(3.5)**	**(1.5)**	**2.5**	**(6.8)**
Credit to other comprehensive income	**2.4**	**1.5**	**–**	**–**	**–**	**–**	**3.9**
Credit direct to equity	**–**	**–**	**–**	**–**	**–**	**0.2**	**0.2**
Other movements	**1.4**	**–**	**(0.7)**	**0.4**	**–**	**–**	**1.1**
At 31 December 2013	**17.3**	**0.4**	**0.4**	**(18.5)**	**(1.5)**	**1.9**	**–**

Notes:

1. A deferred tax asset of £1.2 million at 31 December 2012 was not recognised in respect of capital losses arising on the revaluation of investment property.
2. A deferred tax asset of £3.7 million at 31 December 2013 has not been recognised in respect of provisions and other timing differences in Italy.

	2013 £m	2012 £m
Per balance sheet:		
Deferred tax assets	**19.3**	22.5
Deferred tax liabilities	**(19.3)**	(20.9)
	–	1.6

14. Dividends

	2013 £m	2012 £m
Amounts recognised as distributions to equity holders in the period:		
Final dividend for the year ended 31 December 2012 of 8.0p (2011: nil) per share	**120.0**	–
Interim dividend for the year ended 31 December 2013 of 4.2p (2012: 66.6p) per share	**62.8**	1,000.0
First special interim dividend for the year ended 31 December 2013 of 4.0p (2012: nil) per share	**59.9**	–
	242.7	1,000.0
Second special interim dividend for the year ended 31 December 2013 of 4.0p (2012: nil) per share	**60.0**	–
Proposed final dividend for the year ended 31 December 2013 of 8.4p (2012: 8.0p) per share	**126.0**	120.0

The proposed final dividend is subject to approval by shareholders at the Annual General Meeting on 15 May 2014 and has not been included as a liability in these financial statements.

The trustees of the employee share trusts, waived their entitlement to dividends on shares, which are not held for the benefit of employees' (except for free share awards) which reduced the total dividend paid by £0.3 million (2012: £nil).

15. Earnings and net assets per share, return on equity

Earnings per share is calculated by dividing earnings attributable to the owners of the Company by the weighted average of Ordinary Shares in issue during the period.

Basic

Basic earnings per share is calculated by dividing the earnings attributable to the owners of the Company and the weighted average of Ordinary Shares in issue during the period, excluding Ordinary Shares held as employee trust shares.

	2013 £m	2012 £m
Earnings attributable to owners of the Company	**312.8**	184.3
Weighted average number of Ordinary Shares in issue (millions)	**1,495.4**	1,499.4
Basic earnings per share (pence)	**20.9**	12.3

Diluted

Diluted earnings per share is calculated by dividing the earnings attributable to the owners of the Company by the weighted average of Ordinary Shares in issue during the period adjusted for the dilutive potential Ordinary Shares. The Company has share options and contingently issuable shares as categories of dilutive potential Ordinary Shares.

	2013 £m	2012 £m
Earnings attributable to owners of the Company	**312.8**	184.3
Weighted average number of Ordinary Shares in issue (millions)	**1,495.4**	1,499.4
Effect of dilutive potential of share options and contingently issuable shares (millions)	**5.8**	0.6
Weighted average number of Ordinary Shares for diluted earnings per share (millions)	**1,501.2**	1,500.0
Diluted earnings per share (pence)	**20.8**	12.3

Net asset value and tangible net asset value per share

Net asset value per share is calculated as total shareholders' equity divided by the number of Ordinary Shares in issue at the end of the period. Ordinary Shares in issue exclude shares held by employee share trusts at 31 December 2013 of 5,204,771 (2012: 2,848,991).

Tangible net asset value per share is calculated as total shareholders' equity less goodwill and other intangible assets divided by the number of Ordinary Shares in issue at the end of the period.

The table below analyses net asset and tangible net asset value per share.

At 31 December	**2013 £m**	2012 £m
Net assets	**2,790.0**	2,831.6
Goodwill and other intangible assets	**(500.1)**	(421.5)
Tangible net assets	**2,289.9**	2,410.1
Number of Ordinary Shares in issue (millions)	**1,500.0**	1,500.0
Shares held by employee share trusts (millions)	**(5.2)**	(2.8)
Closing number of Ordinary Shares in issue (millions)	**1,494.8**	1,497.2
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0

Return on equity

The table below details the calculation of return on equity.

	2013 £m	2012 £m
Profit for the year	**312.8**	184.3
Opening shareholders' equity	**2,831.6**	3,612.8
Closing shareholders' equity	**2,790.0**	2,831.6
Average shareholders' equity	**2,810.8**	3,222.2
Return on equity	**11.1%**	5.7%

16. Goodwill and other intangible assets

	Goodwill £m	Other intangible assets £m	Total £m
Cost			
At 1 January 2012	345.2	537.0	882.2
Effect of foreign currency exchange adjustment	(0.6)	(0.9)	(1.5)
Additions	–	96.6	96.6
Fully utilised	–	(282.1)	(282.1)
Impairment losses	–	(21.2)	(21.2)
At 31 December 2012	344.6	329.4	674.0
Effect of foreign currency exchange adjustment	**–**	**0.8**	**0.8**
Additions	**–**	**115.5**	**115.5**
Disposal of subsidiary	**(1.8)**	**–**	**(1.8)**
At 31 December 2013	**342.8**	**445.7**	**788.5**
Accumulated amortisation and impairment			
At 1 January 2012	134.2	382.2	516.4
Charge for the year	–	30.0	30.0
Effect of foreign currency exchange adjustment	(0.6)	(0.7)	(1.3)
Fully utilised	–	(282.1)	(282.1)
Impairment losses	–	(10.5)	(10.5)
At 31 December 2012	133.6	118.9	252.5
Charge for the year	**–**	**37.2**	**37.2**
Effect of foreign currency exchange adjustment	**–**	**0.5**	**0.5**
Disposal of subsidiary	**(1.8)**	**–**	**(1.8)**
At 31 December 2013	**131.8**	**156.6**	**288.4**
Carrying amount			
At 31 December 2013	**211.0**	**289.1**	**500.1**
At 31 December 2012	211.0	210.5	421.5

Goodwill arose on the acquisition of U K Insurance Limited (£141.0 million) and Churchill Insurance Company Limited (£70.0 million), which is allocated across Motor, Home, Rescue and other personal lines and Commercial.

The Group's goodwill is reviewed annually at 30 September for impairment by comparing the recoverable amount of each CGU to which goodwill has been allocated with its carrying value and updated at each reporting date in the event of indicators of impairment.

16. Goodwill and other intangible assets continued

The table below analyses the goodwill of the Group by CGU.

	2013 £m	2012 £m
Motor	**126.4**	126.4
Home	**45.8**	45.8
Rescue and other personal lines	**28.7**	28.7
Commercial	**10.1**	10.1
Total	**211.0**	211.0

There have been no impairments in goodwill in the year ended 31 December 2013 (2012:nil).

The recoverable amount is the higher of the CGU fair value less the costs to sell and its value in use. Value in use is the present value of expected future cash flows from the CGU. Fair value is the amount obtainable for the sale of the CGU in an arm's length transaction between knowledgeable and willing parties.

The recoverable amounts of all CGUs at 30 September were based on the value in use test, using the Group's five-year strategic plan. The long-term growth rates have been based on GDP rates adjusted for inflation. The risk discount rates incorporate observable market long-term government bond yields and average industry betas adjusted for an appropriate risk premium based on independent analysis.

The table below details the recoverable amounts in excess of carrying value for the CGUs where goodwill is held.

CGU	Assumptions			Sensitivity: Impact in recoverable amount of a:		
	Terminal Growth Rate %	Pre-tax discount rate %	Recoverable amount in excess of carrying value £m	1% decrease in terminal growth rate £m	1% increase in pre-tax discount rate £m	1% decrease in forecast pre-tax profit[1] £m
Motor	3.0	11.9	714.3	(176.7)	(246.2)	(24.3)
Home	3.0	11.9	1,339.9	(119.9)	(165.4)	(15.5)
Rescue and other personal lines	3.0	11.9	493.4	(48.6)	(67.0)	(6.2)
Commercial	3.0	11.9	74.0	(32.7)	(45.3)	(4.3)

Note:

1. Reflects a 1% decrease to the profit for each year of the five-year forecast.

17. Property, plant and equipment

	Freehold land and buildings £m	Other equipment £m	Total £m
Cost			
At 1 January 2012	4.0	85.1	89.1
Additions	0.4	63.3	63.7
Disposals	–	(9.2)	(9.2)
Effect of foreign currency exchange adjustment	–	(1.2)	(1.2)
At 31 December 2012	4.4	138.0	142.4
Additions	**10.9**	**28.2**	**39.1**
Disposals	**–**	**(6.3)**	**(6.3)**
Disposal of subsidiary	**–**	**(0.2)**	**(0.2)**
Effect of foreign currency exchange adjustment	**–**	**0.3**	**0.3**
At 31 December 2013	**15.3**	**160.0**	**175.3**
Accumulated depreciation and impairment			
At 1 January 2012	0.8	41.4	42.2
Depreciation charge for the year	0.1	13.0	13.1
Disposals	–	(4.4)	(4.4)
Effect of foreign currency exchange adjustment	–	(0.9)	(0.9)
At 31 December 2012	0.9	49.1	50.0
Depreciation charge for the year	**0.2**	**20.8**	**21.0**
Disposals	**–**	**(3.4)**	**(3.4)**
Impairment losses	**–**	**5.5**	**5.5**
Disposal of subsidiary	**–**	**(0.2)**	**(0.2)**
Effect of foreign currency exchange adjustment	**–**	**0.1**	**0.1**
At 31 December 2013	**1.1**	**71.9**	**73.0**
Carrying amount			
At 31 December 2013	**14.2**	**88.1**	**102.3**
At 31 December 2012	3.5	88.9	92.4

18. Investment property

	2013 £m	2012 £m
At 1 January	**128.9**	69.5
Additions	**87.0**	133.7
Disposals	**–**	(69.5)
Increase / (decrease) in fair value during the year	**7.5**	(4.8)
At 31 December	**223.4**	128.9

Investment properties were purchased during the year to provide an investment return over the long term in accordance with the Group's investment strategy. These properties are managed, on behalf of the Group, by a property services company. The investment properties are measured at fair value which was arrived at on the basis of a valuation carried out at the balance sheet date by independent valuers.

The valuation conforms to international valuation standards. The fair value was determined using a methodology based on recent market transactions for similar properties, which have been adjusted for the specific characteristics of each property within the portfolio. This approach to valuation is consistent with the methodology used in the year ended 31 December 2012. There has been no change to the valuation technique during the year. All investment properties are classified as level 3 under the fair value reporting hierarchy as described in note 2.3. Fair value equates to carrying value.

The lease agreements are drawn up in line with local practice and the Group has no exposure to leases that include contingent rents.

Disposals in the year ended 31 December 2012 comprised freehold property occupied by RBS Group under operating leases.

19. Subsidiaries

The principal subsidiary undertakings of the Group are shown below. Their capital consists of ordinary shares which are unlisted.

Direct Line Versicherung AG, DL Insurance Services Limited and U K Insurance Limited are owned directly by Direct Line Insurance Group plc. Direct Line Insurance S.p.A is owned indirectly through intermediary holding companies. All subsidiaries are included in the Group's consolidated financial information and have an accounting reference date of 31 December.

Name of subsidiary	Place of incorporation and operation	Type of ownership interest (share type)	Proportion of voting power held	Principal activity
Direct Line Insurance S.p.A	Italy	Ordinary	100%	General insurance
Direct Line Versicherung AG	Germany	Ordinary	100%	General insurance
DL Insurance Services Limited	Great Britain	Ordinary	100%	Management services
U K Insurance Limited	Great Britain	Ordinary	100%	General insurance

The above information is provided in relation to principal related undertakings as permitted by Section 410(2) of the Companies Act 2006. Full information on all related undertakings is included in the Annual Return available from Companies House by visiting www.companieshouse.gov.uk .

The Group sold 100% of the share capital of Direct Line Life Insurance Company Limited on 28 November 2013. The fair value of the identifiable assets sold was £159.4 million (including cash and cash equivalents of £20.5 million) and the fair value of identifiable liabilities was £132.1 million. The total cash consideration received was £39.3 million generating a profit on disposal of £12.0 million. The Life business generated a gross earned premium of £35.9 million up to the point of sale (full year 2012: £46.6 million), a net earned premium of £14.6 million (full year 2012 £21.9 million) and operating profit of £7.6 million (full year 2012: £9.4 million).

The Group did not dispose of any other subsidiaries in the year ended 31 December 2013 (2012: no subsidiary disposals).

The Group acquired 100% of the share capital of Direct Line Versicherung AG on 2 April 2012. The fair value of identifiable assets acquired was £368.7 million (including cash and cash equivalents of £39.7 million) and the fair value of identifiable liabilities assumed was £263.5 million. The total cash consideration paid was £105.2 million.

20. Reinsurance assets

	2013 £m	2012 £m
Reinsurers' share of general insurance liabilities (including unearned premium reserve)	**1,064.2**	1,068.0
Impairment provision	**(53.2)**	(60.7)
	1,011.0	1,007.3
Reinsurers' share of life insurance liabilities	**–**	94.7
Total	**1,011.0**	1,102.0

Movements in reinsurance asset impairment provision

	2013 £m	2012 £m
At 1 January	**(60.7)**	(53.9)
Additional provision	**(3.5)**	(7.6)
Utilisation of provision	**2.0**	–
Release to income statement	**9.0**	0.8
At 31 December	**(53.2)**	(60.7)

21. Deferred acquisition costs

	2013 £m	2012 £m
At 1 January	**327.6**	310.5
Net (decrease) / increase in the year	**(7.3)**	18.5
Effect of foreign currency exchange adjustment	**1.2**	(1.4)
At 31 December	**321.5**	327.6

22. Insurance and other receivables

	2013 £m	2012 £m
Receivables arising from insurance and reinsurance contracts:		
Due from policyholders	**927.9**	965.3
Impairment of policyholder receivables	**(7.6)**	(9.7)
Due from agents, brokers and intermediaries	**53.4**	106.6
Impairment of agent, broker and intermediary receivables	**(0.5)**	(0.3)
Due from reinsurers	**19.3**	34.8
Other loans and receivables:		
Accrued interest	**1.2**	2.0
Receivables from related parties	**0.9**	5.1
Other debtors[1]	**127.4**	60.2
Total	**1,122.0**	1,164.0

Note:

1. Includes £42.1 million in respect of a deposit for the purchase of owner occupied property (2012: £nil).

23. Derivative financial instruments

	2013 £m	2012 £m
Derivative assets		
At fair value through the income statement	**40.7**	37.5
Total[1]	**40.7**	37.5
Derivative liabilities		
At fair value through the income statement	**17.8**	4.1
Designated as hedging instruments	**1.5**	2.4
Total[1]	**19.3**	6.5

Note:

1. Derivative financial instruments as shown above are all classified as level 2 under the fair value hierarchy as described in note 2.3. These are measured at fair value, which equates to carrying value.

24. Financial investments

	2013 £m	2012 £m
AFS debt securities		
Corporate	**4,878.1**	4,475.6
Supranational	**365.7**	521.8
Local government	**134.5**	271.1
Sovereign	**1,399.5**	1,842.8
Securitised credit	**227.7**	45.2
Total	**7,005.5**	7,156.5
AFS debt securities		
Fixed interest rate	**6,468.4**	6,854.2
Floating interest rate	**537.1**	302.3
Total	**7,005.5**	7,156.5
Loans and receivables		
Deposits with credit institutions with maturities in excess of three months	**435.7**	645.0
Total	**7,441.2**	7,801.5

24. Financial investments continued

The following table analyses financial instruments held at fair value, which equates to their carrying value, by level of the fair value hierarchy.

	2013 £m	2012 £m
Level 1[1]	**1,393.7**	1,839.9
Level 2[1]	**5,611.8**	5,316.6
Total	**7,005.5**	7,156.5

Notes:

1. Please refer to note 2.3 for details of the fair value hierarchy.
2. The Group held no level 3 securities at 31 December 2013 (2012: £nil).

25. Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	**307.5**	201.7
Short-term deposits with credit institutions[1]	**600.8**	1,306.7
Total	**908.3**	1,508.4

Note:

1. Short-term deposits included £nil (2012: £492.5 million) held by the Group in Global Treasury Funds PLC (an open ended umbrella investment company with variable capital incorporated with limited liability in Ireland). RBS Asset Management (Dublin) Limited is the appointed manager to the fund.

The effective interest rate on short-term deposits with credit institutions for the year ended 31 December 2013 was 0.41% (2012: 0.35%) and average maturity was 14 days (2012: 11 days).

The following table details cash and bank overdrafts for the purposes of the cash flow statement.

	2013 £m	2012 £m
Cash and cash equivalents	**908.3**	1,508.4
Bank overdrafts	**(55.1)**	(90.9)
Total	**853.2**	1,417.5

26. Assets held for sale

	2013 £m	2012 £m
Freehold property held for sale	**1.0**	1.0

The Group intends to dispose of freehold property it no longer utilises at Lumbry Park, Alton. At 31 December 2013, the property is being actively marketed, with no impairment losses recognised in the year ended 31 December 2013 (2012: £nil).

27. Share capital

	2013 Number million	2012 Number million
Issued and fully paid: equity shares		
Ordinary Shares of 10 pence each	**1,500.0**	1,500.0

On 31 August 2012, Board and shareholder resolutions were approved to subdivide the share capital of Direct Line Insurance Group plc from 1.5 billion Ordinary Shares of £1 each to 1.5 billion Ordinary Shares of 10 pence each and 1.5 billion deferred shares of 90 pence each.

The deferred shares were then transferred back to the Company by its then parent, The Royal Bank of Scotland Group plc, for no value and immediately cancelled by the Company. This cancellation has created a non-distributable capital redemption reserve in the Company of £1,350.0 million.

The Group satisfies share-based payments under the Group's share plans primarily through shares purchased in the market and held by employee share trusts.

At 31 December 2013, 5,204,771 Ordinary Shares (2012: 2,848,991) were owned by the employee share trusts with a cost of £10.2 million (2012: £5.0 million), with an undertaking to satisfy the awards of shares in the Company under the Group's share plans.

These shares were purchased by the employee share trusts and are carried at cost. At 31 December 2013, they had an aggregate nominal value of £0.5 million (2012: £0.3 million) and a market value of £13.0 million (2012: £6.2 million).

28. Other reserves

Movements in the revaluation reserve for AFS investments

	Other investment funds £m	AFS Debt securities £m	Total £m
At 1 January 2012	12.7	124.4	137.1
Revaluation during the year – gross	6.3	103.6	109.9
Revaluation during the year – tax	(1.5)	(19.1)	(20.6)
Realised gains – gross	(23.2)	(66.3)	(89.5)
Realised gains – tax	5.7	16.2	21.9
At 31 December 2012	–	158.8	158.8
Revaluation during the year – gross	**–**	**(108.2)**	**(108.2)**
Revaluation during the year – tax	**–**	**27.7**	**27.7**
Realised gains – gross	**–**	**(23.9)**	**(23.9)**
Realised gains – tax	**–**	**5.8**	**5.8**
Realised gain on disposal of subsidiary – gross	**–**	**(1.8)**	**(1.8)**
Realised gain on disposal of subsidiary – tax	**–**	**0.4**	**0.4**
At 31 December 2013	**–**	**58.8**	**58.8**

Movements in the non-distributable reserve

	2013 £m	2012 £m
At 1 January	**63.2**	30.3
Transfer from retained earnings	**29.6**	32.9
At 31 December	**92.8**	63.2

The non-distributable reserve relates to a UK statutory claims equalisation reserve that is calculated in accordance with the rules of the PRA.

29. Subordinated liabilities

	2013 £m	2012 £m
Subordinated dated notes	**486.6**	529.0
Undated subordinated loans	**–**	258.5
Total	**486.6**	787.5

The subordinated dated notes were issued on 27 April 2012 at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year hedge to exchange the fixed rate of interest for a floating rate of three-month LIBOR plus a spread of 706 bps.

During 2013, a credit value adjustment was made to the interest rate hedge to reflect the market value of counterparty credit risk resulting from the majority divestment from RBS Group. This has resulted in an increase in the floating rate to three-month LIBOR plus a spread of 707 bps with effect from 29 July 2013.

29. Subordinated liabilities continued

The nominal £500 million bonds have a redemption date of 27 April 2042. The Group has the option to repay the notes on specific dates from 27 April 2022. If the notes are not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 7.91%.

The notes are unsecured, subordinated obligations of the Group, and rank pari passu without any preference among themselves. In the event of a winding-up or of bankruptcy, they are to be repaid only after the claims of all other creditors have been met.

There have been no defaults on any of the notes during the year. The Group has the option to defer interest payments on the notes but to date has not exercised this right. The aggregate fair value of subordinated dated notes as at 31 December 2013 is £625.4 million (2012: £597.6 million).

The undated subordinated loans were fully repaid on 8 January 2013.

30. Insurance liabilities, unearned premium reserve and reinsurance assets

	2013 £m	2012 £m
Insurance liabilities		
Life insurance (note 31)	–	107.2
General insurance	**5,757.4**	6,291.3
Total	**5,757.4**	6,398.5
Gross general insurance (including unearned premium reserve)		
Claims reported	**3,636.4**	3,969.3
Claims incurred but not reported	**1,992.7**	2,153.9
Claims handling provision	**128.3**	163.8
Liability adequacy provision	–	4.3
Total	**5,757.4**	6,291.3
Unearned premium reserve	**1,818.7**	1,872.9
Total	**7,576.1**	8,164.2
Reinsurers' share of general insurance (including reinsurance unearned premium reserve)		
Claims reported	**(467.5)**	(397.8)
Claims incurred but not reported	**(449.8)**	(511.6)
Total	**(917.3)**	(909.4)
Unearned premium reserve	**(93.7)**	(97.9)
Total	**(1,011.0)**	(1,007.3)
Net general insurance (including unearned premium reserve)		
Claims reported	**3,168.9**	3,571.5
Claims incurred but not reported	**1,542.9**	1,642.3
Claims handling provision	**128.3**	163.8
Liability adequacy provision	–	4.3
Total	**4,840.1**	5,381.9
Unearned premium reserve	**1,725.0**	1,775.0
Total	**6,565.1**	7,156.9

Gross general insurance liabilities

Accident year	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	3,679.1	4,007.5	4,091.6	4,390.5	3,878.1	4,148.0	4,261.9	3,080.5	2,797.3	2,652.5	36,987.0
One year later	(187.2)	(175.8)	(266.1)	(62.0)	23.2	120.0	(98.1)	(80.3)	(168.7)	–	(895.0)
Two years later	(89.8)	(141.7)	(42.0)	(1.1)	43.9	(42.5)	(115.3)	(99.5)	–	–	(488.0)
Three years later	(61.3)	(57.9)	(17.6)	49.4	(38.3)	(24.2)	(55.1)	–	–	–	(205.0)
Four years later	(41.9)	(59.5)	10.1	(7.0)	(22.0)	(101.8)	–	–	–	–	(222.1)
Five years later	(15.2)	15.3	(21.6)	(17.8)	(57.9)	–	–	–	–	–	(97.2)
Six years later	70.5	7.8	(9.1)	(26.3)	–	–	–	–	–	–	42.9
Seven years later	12.8	5.4	(13.4)	–	–	–	–	–	–	–	4.8
Eight years later	22.0	(34.4)	–	–	–	–	–	–	–	–	(12.4)
Nine years later	(29.1)	–	–	–	–	–	–	–	–	–	(29.1)
Current estimate of cumulative claims	3,359.9	3,566.7	3,731.9	4,325.7	3,827.0	4,099.5	3,993.4	2,900.7	2,628.6	2,652.5	35,085.9
Cumulative payments to date	(3,186.6)	(3,447.6)	(3,520.0)	(4,022.7)	(3,528.3)	(3,564.7)	(3,326.3)	(2,201.3)	(1,842.7)	(1,119.6)	(29,759.8)
Liability recognised in balance sheet	**173.3**	**119.1**	**211.9**	**303.0**	**298.7**	**534.8**	**667.1**	**699.4**	**785.9**	**1,532.9**	**5,326.1**
2003 and prior											**303.0**
Claims handling provision											**128.3**
Total gross liability											**5,757.4**

30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

Net general insurance liabilities

Accident year	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	3,486.1	3,869.6	4,030.8	4,341.3	3,816.0	4,113.0	4,219.3	2,946.1	2,570.1	2,401.5	35,793.8
One year later	(169.2)	(159.3)	(249.7)	(81.7)	24.1	70.0	(109.7)	(119.3)	(157.8)	–	(952.6)
Two years later	(94.1)	(159.4)	(52.7)	(23.3)	8.2	(23.0)	(136.4)	(88.1)	–	–	(568.8)
Three years later	(68.3)	(62.0)	(28.2)	17.7	(24.5)	(64.2)	(48.5)	–	–	–	(278.0)
Four years later	(53.3)	(61.6)	9.9	(10.4)	(51.2)	(67.5)	–	–	–	–	(234.1)
Five years later	(13.5)	7.2	(43.5)	(22.4)	(51.2)	–	–	–	–	–	(123.4)
Six years later	60.7	(0.4)	(21.0)	(21.2)	–	–	–	–	–	–	18.1
Seven years later	(4.1)	(12.2)	(14.2)	–	–	–	–	–	–	–	(30.5)
Eight years later	(5.4)	(27.1)	–	–	–	–	–	–	–	–	(32.5)
Nine years later	(18.2)	–	–	–	–	–	–	–	–	–	(18.2)
Current estimate of cumulative claims	3,120.7	3,394.8	3,631.4	4,200.0	3,721.4	4,028.3	3,924.7	2,738.7	2,412.3	2,401.5	33,573.8
Cumulative payments to date	(3,029.2)	(3,317.3)	(3,468.0)	(3,957.6)	(3,490.8)	(3,531.0)	(3,310.0)	(2,110.4)	(1,748.1)	(1,046.4)	(29,008.8)
Liability recognised in balance sheet	**91.5**	**77.5**	**163.4**	**242.4**	**230.6**	**497.3**	**614.7**	**628.3**	**664.2**	**1,355.1**	**4,565.0**
2003 and prior											**146.8**
Claims handling provision											**128.3**
Total net liability											**4,840.1**

Movements in general insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
Claims reported	4,036.9	(318.1)	3,718.8
Incurred but not reported	2,217.5	(281.8)	1,935.7
Claims handling provision	153.2	–	153.2
Liability adequacy provision	3.6	–	3.6
At 1 January 2012	6,411.2	(599.9)	5,811.3
Cash paid for claims settled in the year	(2,949.1)	108.6	(2,840.5)
Increase / (decrease) in liabilities:			
Arising from current-year claims	3,038.2	(227.2)	2,811.0
Arising from prior-year claims	(196.5)	(193.0)	(389.5)
Effect of foreign currency exchange adjustment	(13.2)	2.1	(11.1)
Increase in liability adequacy provision	0.7	–	0.7
At 31 December 2012	6,291.3	(909.4)	5,381.9
Claims reported	3,969.3	(397.8)	3,571.5
Incurred but not reported	2,153.9	(511.6)	1,642.3
Claims handling provision	163.8	–	163.8
Liability adequacy provision	4.3	–	4.3
At 31 December 2012	6,291.3	(909.4)	5,381.9
Cash paid for claims settled in the year	**(2,852.1)**	**149.1**	**(2,703.0)**
Increase / (decrease) in liabilities:			
Arising from current-year claims	**2,894.2**	**(250.9)**	**2,643.3**
Arising from prior-year claims	**(583.9)**	**96.7**	**(487.2)**
Effect of foreign currency exchange adjustment	**12.2**	**(2.8)**	**9.4**
Decrease in liability adequacy provision	**(4.3)**	**–**	**(4.3)**
At 31 December 2013	**5,757.4**	**(917.3)**	**4,840.1**
Claims reported	**3,636.4**	**(467.5)**	**3,168.9**
Incurred but not reported	**1,992.7**	**(449.8)**	**1,542.9**
Claims handling provision	**128.3**	**–**	**128.3**
Liability adequacy provision	**–**	**–**	**–**
At 31 December 2013	**5,757.4**	**(917.3)**	**4,840.1**

Movement in prior-year net claims liabilities by operating segment

	2013 £m	2012 £m
Motor	**(291.9)**	(174.3)
Home	**(43.3)**	(37.4)
Rescue and other personal lines	**(9.0)**	(23.9)
Commercial	**(51.6)**	(56.2)
International	**(39.3)**	(30.2)
Total ongoing	**(435.1)**	(322.0)
Run-off	**(52.1)**	(67.5)
Total	**(487.2)**	(389.5)

30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

Movement in unearned premium reserve

	Gross £m	Reinsurance £m	Net £m
At 1 January 2012	1,931.6	(59.0)	1,872.6
Net decrease in the year	(47.1)	(38.9)	(86.0)
Effect of foreign currency exchange adjustment	(11.6)	–	(11.6)
At 31 December 2012	1,872.9	(97.9)	1,775.0
Net (decrease) / increase in the year	**(61.8)**	**5.0**	**(56.8)**
Effect of foreign currency exchange adjustment	**7.6**	**(0.8)**	**6.8**
At 31 December 2013	**1,818.7**	**(93.7)**	**1,725.0**

31. Life insurance liabilities and reinsurance assets

	2013 £m	2012 £m
Gross life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	102.9
Benefits outstanding	**–**	4.3
Total	**–**	107.2
Reinsurers' share of life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	(91.1)
Benefits outstanding	**–**	(3.6)
Total	**–**	(94.7)
Net life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	11.8
Benefits outstanding	**–**	0.7
Total	**–**	12.5

Movements in life insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
At 1 January 2012	93.0	(78.6)	14.4
Provisions in respect of new and existing business	42.8	(24.7)	18.1
Expected change in existing business provisions	(20.3)	18.3	(2.0)
Variance between actual and expected experience	(4.7)	(6.1)	(10.8)
Other movements	(7.9)	–	(7.9)
At 31 December 2012	102.9	(91.1)	11.8
Provisions in respect of new and existing business	**34.5**	**(21.4)**	**13.1**
Expected change in existing business provisions	**(19.8)**	**17.3**	**(2.5)**
Variance between actual and expected experience	**(3.0)**	**(5.0)**	**(8.0)**
Other movements	**(3.7)**	**–**	**(3.7)**
Disposal[1]	**(110.9)**	**100.2**	**(10.7)**
At 31 December 2013	**–**	**–**	**–**

Note:

1. The Group's Life business was sold on 28 November 2013.

32. Retirement benefit obligations

Defined contribution scheme

The pension charge in respect of the defined contribution scheme for the year ended 31 December 2013 was £25.3 million (2012: £26.0 million).

In addition, certain employees of the Group who were previously members of the RBS Group defined benefit pension scheme transferred to the Group's defined contribution scheme in 2012. As a result of standardising employment terms for all Group employees, which included changes to the employment terms of a small number of Group employees who were members of the RBS Group defined benefit pension scheme, the Group crystallised a debt under section 75 of the UK Pensions Act 1995. Consequently the Group was required to pay into the RBS Group's defined benefit pension scheme (in which those employees ceased to participate) as a result of a deficit in that scheme. The debt was calculated based on the amount needed to secure Direct Line Group's share of the pension liabilities in the pension scheme with an insurance company. An amount of £31.3 million was paid to the RBS Group pension scheme on 29 June 2012 in full and final settlement.

Defined benefit scheme

The Group's defined benefit pension scheme was closed in 2003 although the Group remains the sponsoring employer for obligations to current and deferred pensioners based on qualifying years service and final salaries. The defined benefit scheme is legally separated from the Group with trustees who are required by law to act in the interest of the scheme and of all the relevant stakeholders. The trustees of the pension scheme are responsible for the investment policy with regard to the assets of the scheme.

The weighted average duration of the defined benefit obligations at 31 December 2013 is 20 years (2012: 20 years) using accounting assumptions.

The table below sets out the principal assumptions in respect of the defined benefit scheme.

	2013 **%**	2012 %
Rate of increase in pension payment	**2.1**	2.1
Rate of increase of deferred pensions	**2.6**	2.1
Discount rate	**4.4**	4.5
Inflation rate	**3.5**	2.8

No assumption has been made for salary growth as there are no obligations in the scheme that are linked to future increases in salaries.

Post-retirement mortality assumptions

	2013	2012
Life expectancy at age 60 now:		
Males	**88.4**	87.5
Females	**90.1**	89.4
Life expectancy at age 60 in 20 years' time:		
Males	**90.3**	89.5
Females	**92.2**	91.5

The table below analyses the market value of the scheme assets by type of asset.

	2013 **£m**	2012 £m
Equities	**3.5**	13.9
Index-linked bonds	**13.1**	10.2
Government bonds	**5.7**	6.5
Corporate bonds	**42.9**	32.5
Other	**0.8**	0.6
Total market value of assets	**66.0**	63.7

Virtually all debt and equity instruments have quoted prices on active markets.

32. Retirement benefit obligations continued

Movement in net pension (deficit) / surplus

	Fair value of scheme assets £m	Present value of defined benefit obligations £m	Net pension surplus / (deficit) £m
At 1 January 2012	56.7	(54.1)	2.6
Income statement:			
Net interest income / (cost)[1,2]	3.5	(2.7)	0.8
Statement of comprehensive income:			
Actuarial gains / (losses) arising from experience adjustments	2.2	(0.1)	2.1
Actuarial losses arising from changes in financial assumptions	–	(5.5)	(5.5)
Contributions by employer	2.5	–	2.5
Benefits paid	(1.2)	1.2	–
At 31 December 2012	63.7	(61.2)	2.5
Income statement:			
Net interest income / (cost)[1,2]	**2.3**	**(2.7)**	**(0.4)**
Statement of comprehensive income:			
Actuarial losses arising from experience adjustments	**(1.3)**	**(0.2)**	**(1.5)**
Actuarial losses arising from changes in financial assumptions	**–**	**(4.4)**	**(4.4)**
Actuarial losses arising from changes in demographic assumptions	**–**	**(1.0)**	**(1.0)**
Contributions by employer	**2.8**	**–**	**2.8**
Benefits paid	**(1.5)**	**1.5**	**–**
At 31 December 2013	**66.0**	**(68.0)**	**(2.0)**

Notes:

1. The income / (cost) in the income statement has been included under other operating expenses.
2. In accordance with IAS 19 'Employee benefits revised' the net interest cost has been calculated by applying the discount rate to the deficit (2012: surplus) in the scheme. The change in IAS 19 set out in 'Adoption of new and revised standards' in note 1, if applied to the Group's result for the year ended 31 December 2012, would have resulted in a decrease in the net interest income to the income statement of £0.6 million. A charge of this amount has been made to net interest income in the income statement and a credit in the statement of comprehensive income for year ended 31 December 2013.

The table below details the history of the scheme for the current and prior years.

	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Present value of defined benefit obligations	**(68.0)**	(61.2)	(54.1)	(54.5)	(60.8)
Fair value of scheme assets	**66.0**	63.7	56.7	54.4	47.2
Net (deficit) / surplus	**(2.0)**	2.5	2.6	(0.1)	(13.6)
Experience adjustment (losses) / gains on scheme liabilities	**(0.2)**	(0.1)	0.4	0.5	2.6
Experience adjustment (losses) / gains on scheme assets	**(1.3)**	2.2	(2.6)	3.1	5.4

Sensitivity analysis

The table below provides a sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group. This sensitivity analysis has been selected to reflect the changes to discounted cash flows as a result of changes to the discount rate, inflation rate and mortality assumptions. The methodology adopted involves actuarial techniques.

	2013		2012	
	Impact on pension cost £m	**Impact on present value of scheme obligations £m**	Impact on pension cost £m	Impact on present value of scheme obligations £m
Discount rate				
0.25% increase in discount rate	**(0.2)**	**(3.5)**	(0.2)	(3.0)
0.25% decrease in discount rate	**0.1**	**3.6**	0.1	3.2
Inflation rate				
0.25% increase in inflation rate	**–**	**1.8**	0.1	3.1
0.25% decrease in inflation rate	**–**	**(1.8)**	(0.1)	(3.0)
Life expectancy				
1 year increase in life expectancy	**0.1**	**1.5**	0.1	1.5
1 year decrease in life expectancy	**(0.1)**	**(1.6)**	(0.1)	(1.5)

The most recent funding valuation of the defined benefit scheme took place at 1 October 2011. The Group has agreed to make contributions of £2.8 million per annum from 2013 to 2016 to meet the funding deficit, and does not anticipate any material change to the level of contributions before the next valuation, which is due on 1 October 2014.

33. Share-based payments

The Group operates equity-settled, share-based compensation plans in the form of free shares awards, a Long Term Incentive Plan, Direct Line Share Incentive Plans and an Annual Incentive Plan, details of which are set out below together with their financial impact:

Free share awards

During the year ended 31 December 2012, upon listing on the London Stock Exchange, the Group offered all employees a 'free share' award granting shares to the value of £250 to each eligible employee free of charge. These awards have no performance criteria attached, vest on the third anniversary of the award grant date subject to completion of three years' continuing employment (or on leaving employment in certain circumstances) and will be satisfied using market-purchased shares. The number of shares initially granted was 1.9 million with an estimated fair value at grant of £3.9 million.

Long-Term Incentive Plan

Senior management are eligible to participate in the LTIP and awards are granted in the form of nil-cost options. Under the plan, the shares vest at the end of a three-year period dependent upon the following: continued employment by the Group and achieving predefined performance conditions associated with TSR and RoTE.

Conditional awards were made in the year ended 31 December 2013 over 3.0 million Ordinary Shares with an estimated fair value at grant of £4.9 million in March and 2.5 million Ordinary Shares with an estimated fair value at grant of £4.3 million in August (2012: 3.2 million Ordinary Shares with an estimated fair value at grant of £5.0 million in November) under the Group's LTIP.

The estimated fair value of the LTIP share awards with market-based performance conditions was calculated using the Monte-Carlo simulation model.

The table below details the inputs into the model.

	2013	2012
Weighted average assumptions during the year:		
Share price	**208p**	194p
Exercise price	**0p**	0p
Volatility of Company share price	**26%**	27%
Average comparator volatility	**32%**	32%
Expected life	**3 years**	3 years
Risk-free rate	**0.5%**	0.3%

33. Share-based payments continued

As historic data is not available for the Group, expected volatility was determined by calculating the median historic volatility for a group of comparable companies using daily share price data over a period commensurate with the expected life assumption. These comparable companies are classified as being in the insurance sector in the FTSE 350.

Plan participants are entitled to receive additional shares in respect of dividends paid to shareholders over the vesting period. Therefore no deduction has been made from the fair value of awards in respect of dividends.

Expected life was based on the contractual life of the awards and adjusted based on management's best estimate, for the effects of exercise restrictions and behavioural considerations.

RBS Group LTIP awards

Prior to October 2012, certain employees benefited from share-based awards originally granted by RBS Group. The expense incurred in respect of awards granted by RBS Group to Direct Line Group employees is not material and has been included within operating expenses.

RBS Group has indemnified Direct Line Group for all future costs in respect of RBS Group share-based awards made to Direct Line Group employees. All costs in respect of these share awards for Direct Line Group employees have since been borne by RBS Group.

The RBS Group Remuneration Committee has agreed that RBS Group will be responsible for the settlement of the following outstanding LTIP awards, with no charge to be made to Direct Line Group:

- LTIP awards in the year ended 31 December 2011 – expected to vest in March 2014
- LTIP awards in the year ended 31 December 2012 – expected to vest in March 2015

The 2011 and 2012 LTIP awards will be settled with Company Ordinary Shares currently held by RBS Group. Details of the RBS Group legacy share based payments are set out in the Directors' remuneration report on page 98.

Direct Line Share Incentive Plans

The HMRC approved Buy-As-You-Earn Plan in the UK and an International plan, mirroring the UK plan for Italy, were both launched during the year ended 31 December 2013. The International plan is being further rolled out to employees in Germany and it is expected that this process will be completed in 2014.

The Group's Share Incentive Plans entitle employees to purchase shares from pre-tax pay for between £10 and £125 per month, or Euro equivalent, and receive one matching share for every two shares purchased.

Since commencement of the Share Incentive Plans during the year ended 31 December 2013, matching share awards have been granted over 0.3 million Ordinary Shares in relation to these schemes in the year with an estimated fair value of £0.6 million. The fair value of each matching share award is estimated using the market value at the date of grant.

Under the Share Incentive Plans, the shares vest at the end of a three-year period dependent upon the following: continued employment by the Group (or on leaving employment in certain circumstances) and continued ownership of the associated purchased shares up to the point of vesting.

Annual Incentive Plan

Executive Directors and certain members of senior management are eligible for awards under the AIP, of which at least 40% is granted in the form of a nil-cost option.

In March 2013 awards were made over 1.1 million Ordinary Shares under this plan with an estimated fair value of £2.2 million based on the market value on the date of grant.

The awards outstanding at 31 December 2013 have no performance criteria attached, other than the requirement that the employee remains in employment with the Group for three years from the date of award (with the exception of the awards to the Chief Executive – specific terms in this case are set out in the Directors' remuneration report).

The following table details the outstanding number of share awards in issue (all nil-cost).

	2013 Number of share options million	2012 Number of share options million
At 1 January	**5.1**	–
Granted during the year	**6.9**	5.1
Forfeited during the year	**(0.4)**	–
Exercised during the year	**(0.2)**	–
At 31 December	**11.4**	5.1
Exercisable at 31 December	**0.2**	–

In respect of the outstanding options at 31 December 2013, the weighted average remaining contractual life is 2.20 years (2012: 2.85 years). No share options expired during the year (2012: nil).

The weighted average share price during the period of exercise was £2.17 in the year ended 31 December 2013 (2012: not applicable).

The Group recognised total expenses of £4.1 million in the year ended 31 December 2013 (2012: £0.3 million) relating to equity settled share-based compensation plans.

Further information on share based payments in respect of Directors is provided in the Directors' remuneration report.

34. Trade and other payables including insurance payables

	2013 £m	2012 £m
Due to agents, brokers and intermediaries	**6.2**	6.9
Due to reinsurers	**81.0**	81.9
Due to insurance companies	**13.6**	13.8
Due to related parties	**58.7**	34.7
Trade creditors and accruals	**255.8**	201.0
Other creditors	**174.3**	107.8
Other taxes	**80.6**	81.7
Provisions	**134.9**	114.2
Deferred income	**13.2**	12.6
Total	**818.3**	654.6

Movement in provisions during the year

	Regulatory levies £m	Restructuring £m	Other[1] £m	Total £m
At 1 January 2013	33.2	30.9	50.1	114.2
Additional provision	**36.3**	**51.9**	**67.2**	**155.4**
Utilisation of provision	**(42.2)**	**(45.9)**	**(39.3)**	**(127.4)**
Releases to income statement	**–**	**(3.3)**	**(4.0)**	**(7.3)**
At 31 December 2013	**27.3**	**33.6**	**74.0**	**134.9**

Note:

1. Other provisions include £22.5 million (2012: £11.0 million) for costs associated with onerous contracts in respect of leasehold properties.

35. Notes to the consolidated cash flow statement

	2013 £m	2012 £m
Profit for the year	**312.8**	184.3
Adjustments for:		
Investment income	**(188.6)**	(199.3)
Instalment income	**(117.8)**	(125.4)
Other operating losses	**0.7**	2.1
Net fair value (gain) / loss on assets at fair value through income statement	**(7.5)**	4.8
Finance costs	**37.7**	28.7
Equity-settled share-based payment transactions	**4.1**	0.3
Tax charge	**111.1**	64.8
Depreciation and amortisation expenses	**58.2**	43.1
Non-cash movement in demerger reserve	**–**	24.6
Impairment of property, plant and equipment, goodwill and intangible assets	**5.5**	10.7
Impairment movements on reinsurance contracts	**(7.5)**	6.8
Profit on sale of AFS financial investments	**(25.7)**	(89.4)
Loss on sale of property, plant and equipment	**2.9**	4.8
Profit on disposal of subsidiary	**(12.0)**	–
Operating cash flows before movements in working capital	**173.9**	(39.1)
Movements in working capital:		
Net decrease in net insurance liabilities including reinsurance assets and deferred acquisition costs	**(594.8)**	(532.5)
Net (increase) / decrease in prepayments and accrued income and other assets	**(13.1)**	9.6
Net decrease in insurance and other receivables	**34.3**	86.5
Net increase / (decrease) in trade and other payables including insurance payables	**175.9**	(253.4)
Contribution to retirement benefit obligations	**(2.8)**	(2.5)
Cash used by operations	**(226.6)**	(731.4)
Taxes paid	**(80.2)**	(232.4)
Finance costs	**–**	(2.0)
Cash flow hedges	**(0.2)**	(0.2)
Net cash flow used by operating activities before investment of insurance assets	**(307.0)**	(966.0)
Interest received	**574.2**	327.7
Rental income received from investment property	**11.4**	4.4
Purchases of investment property	**(87.0)**	(133.7)
Proceeds on disposal of investment property	**–**	69.5
Distributions received from other investment funds	**–**	3.1
Proceeds on disposal / maturity of AFS financial investments	**3,147.8**	4,021.6
Net decrease in investment balances held with credit institutions	**209.3**	844.6
Purchases of AFS financial investments	**(3,422.7)**	(3,132.4)
Cash generated from investment of insurance assets	**433.0**	2,004.8

36. Contingent liabilities

The Group did not have any contingent liabilities at 31 December 2013 (2012: none).

37. Commitments

Operating lease commitments

The Group has entered cancellable and non-cancellable operating lease agreements for vehicles and other assets.

	2013 £m	2012 £m
Minimum lease payments under operating leases recognised as an expense in the year	**35.0**	7.5

The following table analyses the outstanding commitments under cancellable and non-cancellable operating leases by the period in which they fall due.

	2013 £m	2012 £m
Within one year	**29.8**	33.0
In the second to fifth years inclusive	**85.0**	92.3
After five years	**248.9**	250.5
Total	**363.7**	375.8

Operating lease commitments where the Group is the lessor

The following table analyses future aggregate minimum lease payments receivable under non-cancellable operating leases.

	2013 £m	2012 £m
Within one year	**13.3**	7.8
In the second to fifth years inclusive	**45.3**	26.6
After five years	**85.9**	41.2
Total	**144.5**	75.6

38. Classification of financial instruments

The following tables analyse the Group's financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Non-financial assets and liabilities outside the scope of IAS 39 are shown separately. Other than those financial assets and liabilities stated at fair value below, the carrying value of all other financial assets and liabilities, with the exception of subordinated liabilities, equals their fair value.

	Financial assets / liabilities					
At 31 December 2013	At fair value £m	Available-for-sale £m	Loans and receivables £m	At amortised cost £m	Non-financial assets / liabilities £m	**Total £m**
Assets						
Goodwill and other intangible assets	–	–	–	–	500.1	**500.1**
Property, plant and equipment	–	–	–	–	102.3	**102.3**
Investment property	–	–	–	–	223.4	**223.4**
Reinsurance assets	–	–	–	–	1,011.0	**1,011.0**
Deferred tax assets	–	–	–	–	19.3	**19.3**
Current tax assets	–	–	–	–	1.3	**1.3**
Deferred acquisition costs	–	–	–	–	321.5	**321.5**
Insurance and other receivables	–	–	1,122.0	–	–	**1,122.0**
Prepayments, accrued income and other assets	–	–	–	–	95.7	**95.7**
Derivative financial instruments	40.7	–	–	–	–	**40.7**
Financial investments	–	7,005.5	435.7	–	–	**7,441.2**
Cash and cash equivalents	–	–	908.3	–	–	**908.3**
Assets held for sale	–	–	–	–	1.0	**1.0**
Total assets	**40.7**	**7,005.5**	**2,466.0**	**–**	**2,275.6**	**11,787.8**
Liabilities						
Subordinated liabilities	–	–	–	486.6	–	**486.6**
Insurance liabilities	–	–	–	–	5,757.4	**5,757.4**
Unearned premium reserve	–	–	–	–	1,818.7	**1,818.7**
Retirement benefit obligations	–	–	–	–	2.0	**2.0**
Borrowings	–	–	–	55.1	–	**55.1**
Derivative financial instruments	19.3	–	–	–	–	**19.3**
Trade and other payables including insurance payables	–	–	–	683.4	134.9	**818.3**
Deferred tax liabilities	–	–	–	–	19.3	**19.3**
Current tax liabilities	–	–	–	–	21.1	**21.1**
Total liabilities	**19.3**	**–**	**–**	**1,225.1**	**7,753.4**	**8,997.8**
Total equity						**2,790.0**
Total equity and liabilities						**11,787.8**

At 31 December 2012	Financial assets / liabilities At fair value £m	Available-for-sale £m	Loans and receivables £m	At amortised cost £m	Non-financial assets / liabilities £m	Total £m
Assets						
Goodwill and other intangible assets	–	–	–	–	421.5	421.5
Property, plant and equipment	–	–	–	–	92.4	92.4
Investment property	–	–	–	–	128.9	128.9
Reinsurance assets	–	–	–	–	1,102.0	1,102.0
Deferred tax assets	–	–	–	–	22.5	22.5
Current tax assets	–	–	–	–	5.5	5.5
Deferred acquisition costs	–	–	–	–	327.6	327.6
Insurance and other receivables	–	–	1,164.0	–	–	1,164.0
Prepayments, accrued income and other assets	–	–	–	–	82.6	82.6
Derivative financial instruments	37.5	–	–	–	–	37.5
Retirement benefit asset	–	–	–	–	2.5	2.5
Financial investments	–	7,156.5	645.0	–	–	7,801.5
Cash and cash equivalents	–	–	1,508.4	–	–	1,508.4
Assets held for sale	–	–	–	–	1.0	1.0
Total assets	37.5	7,156.5	3,317.4	–	2,186.5	12,697.9
Liabilities						
Subordinated liabilities	–	–	–	787.5	–	787.5
Insurance liabilities	–	–	–	–	6,398.5	6,398.5
Unearned premium reserve	–	–	–	–	1,872.9	1,872.9
Borrowings	–	–	–	90.9	–	90.9
Derivative financial instruments	6.5	–	–	–	–	6.5
Trade and other payables including insurance payables	–	–	–	540.4	114.2	654.6
Deferred tax liabilities	–	–	–	–	20.9	20.9
Current tax liabilities	–	–	–	–	34.5	34.5
Total liabilities	6.5	–	–	1,418.8	8,441.0	9,866.3
Total equity						2,831.6
Total equity and liabilities						12,697.9

39. Related parties

On 13 March 2013, RBS Group sold 16.8% of the Company's Ordinary Shares and ceased to be the controlling shareholder of Direct Line Group. On 20 September 2013, RBS Group sold a further 20.0% of the Company's Ordinary Shares, which is a further step towards complete disposal by the end of 2014. At 31 December 2013, RBS Group held 28.5% of the issued Ordinary Share capital and the Group is treated as an associated undertaking in the RBS Group results. The UK Government through HM Treasury is the ultimate controlling party of RBS Group and is as a consequence a related party of Direct Line Group. The UK Government's shareholding is managed by UK Financial Investments Limited, a company wholly owned by the UK Government. This gives rise to related party transactions and balances, specifically in respect of tax with HMRC and debt security investments with the UK Government.

Transactions with RBS Group

	2013 £m	2012 £m
Sale of insurance contracts and other services	**3.2**	6.9
Purchase of services	**145.8**	270.7

Sale and purchase of products and services are conducted on an arm's length basis.

Purchase of services, in the year ended 31 December 2012 above, include share-based payment costs for key managers and other staff.

Year end balances arising from cash and investment transactions with members of the RBS Group

	2013 £m	2012 £m
Cash at bank	**64.7**	69.1
Short-term bank deposits	**–**	28.8
Bank overdrafts	**(55.1)**	(90.9)
Derivative financial assets	**20.0**	25.4
Derivative financial liabilities	**(18.5)**	(2.4)
Term deposits	**35.0**	50.0
AFS debt securities	**48.6**	75.0
Total	**94.7**	155.0

Year end balances arising from sales and purchases of products and services to and from RBS Group

	Amounts owed by related parties		Amounts owed to related parties	
	2013 £m	2012 £m	**2013 £m**	2012 £m
Total	**0.9**	5.1	**58.7**	34.7

Movement in amounts owed by / to RBS Group

	Amounts owed by related parties		Amounts owed to related parties	
	2013 £m	2012 £m	**2013 £m**	2012 £m
At 1 January	**5.1**	7.7	**34.7**	158.7
Transactions in the year	**0.2**	68.0	**147.1**	294.6
Settled in the year	**(4.4)**	(70.6)	**(123.1)**	(418.6)
At 31 December	**0.9**	5.1	**58.7**	34.7

Included in transactions within amounts owed by related parties in the year ended 31 December 2012 is £69.5 million, invoiced to and paid by RBS Group for the purchase of investment properties.

Included in transactions within amounts owed to related parties in the year ended 31 December 2012 is an amount of £39.3 million, invoiced by and paid to RBS Group for the acquisition of furniture, fittings and IT hardware. Furthermore, also included is an amount of £31.3 million paid to the RBS Group pension scheme (see note 32 for further details).

Loans from RBS Group

	2013 £m	2012 £m
Total	–	–

Movement in loans from RBS Group

	2013 £m	2012 £m
At 1 January	–	247.7
Loan repayments made	–	(246.4)
Interest charged	–	2.7
Interest settled	–	(2.7)
Effect of foreign currency exchange adjustment	–	(1.3)
At 31 December	–	–

During the year ended 31 December 2012, the Group repaid its loans from RBS Group in preparation for operational separation.

Compensation of key management

	2013 £m	2012 £m
Short-term employee benefits	**9.1**	7.1
Post-employment benefits	**0.2**	0.6
Termination benefits	**0.2**	2.2
Share-based payments	**1.9**	0.1
Total	**11.4**	10.0

For the purposes of IAS 24 'Related party disclosures', key management personnel comprise the Directors of the Company, Non-Executive Directors and members of the Executive Committee.

40. Post balance sheet events

On 5 February 2014 the Group sold 100% of the share capital of Tracker Network (UK) Limited to Lysanda Limited.

During the first quarter of 2014 the UK has seen adverse weather conditions resulting from storm damage and severe flooding. The Group's preliminary estimate of the costs of Home claims, until the 22 February 2014, is in the range of £70 million to £90 million. The Group has also experienced weather-related claims of approximately £20 million in its Commercial division.

Parent Company balance sheet

As at 31 December 2013

	Notes	2013 £m	2012 £m
Assets			
Investments in subsidiary undertakings	2	**3,181.5**	3,226.1
Other receivables	3	**528.8**	521.7
Current tax assets	4	**1.6**	4.5
Cash and cash equivalents	5	**6.8**	268.3
Total assets		**3,718.7**	4,020.6
Equity			
Share capital	6	**150.0**	150.0
Capital redemption reserve		**1,450.0**	1,450.0
Share based payment reserve		**3.9**	0.3
Retained earnings		**1,611.9**	1,661.5
Total equity		**3,215.8**	3,261.8
Liabilities			
Subordinated liabilities	7	**502.4**	501.7
Derivative financial instruments	8	**–**	1.7
Borrowings	9	**–**	255.4
Trade and other payables	10	**0.5**	–
Total liabilities		**502.9**	758.8
Total equity and liabilities		**3,718.7**	4,020.6

The attached notes on pages 171 to 174 form an integral part of these separate financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 25 February 2014. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Direct Line Insurance Group plc

Registration No. 02280426

Parent Company statement of comprehensive income
For the year ended 31 December 2013

	2013 £m	2012 £m
Profit for the year	**193.1**	1,240.4
Total comprehensive income for the year attributable to owners of the Company	**193.1**	1,240.4

Parent Company statement of changes in equity
For the year ended 31 December 2013

	Share capital £m	Capital redemption reserve £m	Share based payment reserve £m	Retained earnings £m	Total equity £m
Balance at 31 December 2011	1,500.0	100.0	–	1,421.1	3,021.1
Total comprehensive income for the year	–	–	–	1,240.4	1,240.4
Share redemption	(1,350.0)	1,350.0	–	–	–
Dividends paid	–	–	–	(1,000.0)	(1,000.0)
Credit to equity for equity-settled share based payments	–	–	0.3	–	0.3
Balance at 31 December 2012	150.0	1,450.0	0.3	1,661.5	3,261.8
Total comprehensive income for the year	–	–	–	193.1	193.1
Dividends paid	–	–	–	(242.7)	(242.7)
Credit to equity for equity-settled share based payments	–	–	4.1	–	4.1
Shares distributed by employee trusts	–	–	(0.5)	–	(0.5)
Balance at 31 December 2013	**150.0**	**1,450.0**	**3.9**	**1,611.9**	**3,215.8**

The attached notes on pages 171 to 174 form an integral part of these separate financial statements.

Parent Company cash flow statement

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Net cash (used by) /generated from operating activities	12	**(3.0)**	7.4
Cash flows from investing activities			
Interest received on loans to subsidiary undertakings		**47.5**	23.8
Dividends received from subsidiary undertakings		**220.8**	1,545.0
Acquisition of investments in subsidiary undertakings		**(9.1)**	(105.2)
Disposal of investments in subsidiary undertakings	2	**39.3**	–
Cash flows from net investment hedges		**(5.3)**	–
Net cash generated from investing activities		**293.2**	1,463.6
Cash flows from financing activities			
Dividends paid		**(242.7)**	(1,000.0)
Proceeds on issue of subordinated liabilities		**–**	493.0
Finance costs		**(46.3)**	(23.1)
Repayment of borrowings from related parties		**(255.0)**	(322.5)
Proceeds of borrowings from related parties		**–**	120.9
Net increase in loans advanced to subsidiary undertakings		**(7.7)**	(503.1)
Net cash used by financing activities		**(551.7)**	(1,234.8)
Net (decrease) / increase in cash and cash equivalents		**(261.5)**	236.2
Cash and cash equivalents at the beginning of the year	5	**268.3**	32.1
Cash and cash equivalents at the end of the year	5	**6.8**	268.3

The attached notes on pages 171 to 174 form an integral part of these separate financial statements

1. Accounting policies

Basis of preparation

Direct Line Insurance Group plc, incorporated in the UK, is the ultimate parent undertaking of the Direct Line Group. The principal activity of the Company is managing its investments in subsidiaries, raising funds for the Group, providing loans to subsidiaries and the receipt and payment of dividends.

The Company's financial statements are prepared in accordance with IFRSs as issued by the IASB and are presented in accordance with the Companies Act 2006. In accordance with the exemption permitted under section 408 of Companies Act 2006, the Company's income statement and related notes have not been presented in these separate financial statements.

The accounting policies that are used in the preparation of these separate financial statements are consistent with the accounting policies used in the preparation of the consolidated financial statements of Direct Line Insurance Group plc as set out in those financial statements.

The additional accounting policies that are specific to the separate financial statements of the Company are set out below.

Investment in subsidiaries

Investments in subsidiaries are stated at cost less any impairment.

Dividend income

Dividend income from investments in subsidiaries is recognised when the right to receive payment is established.

2. Investment in subsidiary undertakings

	2013 £m	2012 £m
At 1 January	**3,226.1**	3,415.3
Additions	**13.2**	105.5
Disposals	**(50.7)**	–
Impairments	**(10.8)**	(291.8)
Effect of foreign currency exchange adjustment	**3.7**	(2.9)
At 31 December	**3,181.5**	3,226.1

The Company sold 100% of the share capital of its subsidiary Direct Line Life Insurance Company Limited on 28 November 2013. The carrying value of the investment in the Life business was £50.7 million at the date of sale. The total cash consideration received was £39.3 million generating a loss on disposal of £11.4 million.

Full details of investments in principal subsidiaries are set out in note 19 to the consolidated financial statements.

3. Other receivables

	2013 £m	2012 £m
Loans to subsidiary undertakings[1]	**528.8**	521.4
Receivables from subsidiary undertakings	**–**	0.3
Total	**528.8**	521.7
Current	**28.8**	21.7
Non-current	**500.0**	500.0
Total	**528.8**	521.7

Note:

1. Included in loans to subsidiary undertakings is a £500 million unsecured subordinated loan to U K Insurance Limited. The loan was advanced on 27 April 2012 at a fixed rate of 9.5% with a repayment date of 27 April 2042. There is an option to repay the loan on specific dates from 27 April 2022. If the loan is not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 8.16%.

4. Current tax assets

	2013 £m	2012 £m
Corporation tax recoverable	**1.6**	4.5

5. Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	**0.1**	–
Short-term deposits with credit institutions:		
Third parties	**6.7**	263.6
Related parties – RBS Group	**–**	4.7
	6.7	268.3
Total	**6.8**	268.3

6. Share capital

Full details of the share capital of the Company are set out in note 27 to the consolidated financial statements.

7. Subordinated liabilities

	2013 £m	2012 £m
Subordinated dated notes	**502.4**	501.7

The subordinated dated notes were issued on 27 April 2012 at a fixed rate of 9.25%. The nominal £500.0 million bonds have a redemption date of 27 April 2042. The Company has the option to repay the notes on specific dates from 27 April 2022. If the notes are not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 7.91%.

The notes are unsecured, subordinated obligations of the Company, and rank pari passu without any preference among themselves. In the event of a winding up or of insolvency, they are to be repaid only after the claims of all other creditors have been met.

There have been no defaults on any of the notes during the year. The Company has the option to defer interest payments on the notes but to date has not exercised this right.

The aggregate fair value of subordinated dated notes at 31 December 2013 is £625.4 million (2012: £597.6 million).

8. Derivative financial instruments

	2013		2012	
	Notional amounts £m	**Liabilities £m**	Notional amounts £m	Liabilities £m
Forward foreign exchange contracts[1]	**–**	**–**	134.0	1.7

Note:

1. The derivative was held with RBS Group.

9. Borrowings

	2013 £m	2012 £m
Loans from subsidiary undertakings	–	255.4
Total	–	255.4
Current	–	255.4

10. Trade and other payables

	2013 £m	2012 £m
Payables to subsidiary undertakings	0.5	–

11. Dividends

Full details of the dividends paid by the Company are set out in note 14 to the consolidated financial statements.

12. Cash generated from operations

	2013 £m	2012 £m
Profit for the period	193.1	1,240.4
Adjustments for:		
Impairment in subsidiary undertakings	10.8	291.8
Investment income	(268.4)	(1,578.1)
Other operating (gain) / loss	(0.2)	1.3
Finance costs	47.1	41.6
Loss on disposal of subsidiary undertaking	11.4	–
Tax credit	(1.3)	(5.5)
Operating cash flows before movements in working capital	(7.5)	(8.5)
Net decrease in related party balances	0.8	23.4
Tax received	4.2	2.3
Finance costs	(0.5)	(9.8)
Cash (used by) / generated from operations	(3.0)	7.4

13. Related parties

Direct Line Insurance Group plc, which is incorporated in England and Wales, is the ultimate parent undertaking of the Direct Line Group of companies.

The Company is an associate of RBS Group.

During the year RBS Group sold 551.7 million of the Company's Ordinary Shares, representing 36.8% of the total share capital of the Company. Following the sale, the RBS Group shareholding in Direct Line Group fell to 28.5%. Full details of related parties are set out in note 39 to the consolidated financial statements.

The following transactions were carried out with related parties:

Sale of services

	2013 £m	2012 £m
Interest income from subsidiary undertakings	**47.4**	32.9

Interest income from loans to subsidiary undertakings was charged at rates ranging from 0.5% to 9.50% (2012: 0.51% to 9.50%).

	2013 £m	2012 £m
Dividend income from subsidiary undertakings	**220.8**	1,545.0

Purchase of services

	2013 £m	2012 £m
Management fees payable to subsidiary undertakings	**7.7**	8.7
Interest payable to subsidiary undertakings	**0.1**	7.1
Interest payable to RBS Group	**–**	2.7
Total	**7.8**	18.5

Interest charged on borrowings from related parties were at rates ranging from 0.5% to 2.0% (2012: 0.51% to 1.92%).

14. Share-based payments

Full details of share-based compensation plans are provided in note 33 to the consolidated financial statements.

15. Risk management

The risks faced by the Company are considered to be from its investment in subsidiaries. Its risks are considered to be the same as those in the operations of the Group itself and details of the key risks to the Group and the steps taken to manage them are disclosed in the Risk management section of the consolidated financial statements (note 3).

16. Directors and key management remuneration

The Directors and key management of the Group and the Company are the same. The aggregate emoluments of the Directors are set out in note 10 of the consolidated financial statements, the compensation for key management is set out in note 39 of the consolidated financial statements and the remuneration and pension benefits payable in respect of the highest paid Director, are included in the Directors' remuneration report in the Governance section of the Annual Report & Accounts.