Delivering performance

John Reizenstein, Chief Financial Officer

"In our first full year as a stand-alone listed Group, we showed good progress towards our targets and delivered improved returns to shareholders."

Against a backdrop of competitive markets, the Group made progress on its financial targets, achieving a COR for ongoing operations[1] of 96.1% and a 16.0% RoTE[2]. We maintained a strong capital position, with a conservative approach to reserving and a high-quality investment portfolio.

Highlights

- Operating profit[1] of £526.5 million for 2013, up 14.2% (2012: £461.2 million) and total Group profit before tax of £423.9 million (2012: £249.1 million)
- Gross written premium[1] 4.1% lower for 2013, reflecting competitive market conditions in UK personal lines, partially offset by growth in International and Commercial
- Combined operating ratio[1] of 96.1% for 2013, an improvement of 3.1 percentage points against last year (2012: 99.2%). This arises from improved underwriting and lower costs
- Prior-year reserve releases for ongoing operations[1] amounted to £435.1 million (2012: £322.0 million)
- Return on tangible equity[2] from ongoing operations of 16.0% for 2013 (2012: 11.5% and pro forma[3] 13.4%)
- Net asset value per share of 186.6 pence and tangible net asset value per share of 153.2 pence
- Final dividend proposed of 8.4 pence per share

For the year ended 31 December	2013 £m	2012 £m
Ongoing operations[1]		
In-force policies (thousands)	**18,475**	19,648
Gross written premium	**3,826.6**	3,990.6
Net earned premium	**3,520.6**	3,708.7
Underwriting profit	**138.2**	28.2
Instalment and other operating income	**180.2**	198.3
Investment return	**208.1**	234.7
Operating profit – ongoing operations[1]	**526.5**	461.2
Run-off segment	**63.6**	6.1
Restructuring and other one-off costs	**(140.5)**	(189.5)
Operating profit	**449.6**	277.8
Finance costs	**(37.7)**	(28.7)
Gain on disposal of subsidiary	**12.0**	–
Profit before tax	**423.9**	249.1
Tax	**(111.1)**	(64.8)
Profit after tax	**312.8**	184.3
Of which is ongoing operations[4]	**375.2**	326.5

Key metrics – ongoing operations[1]		
Loss ratio	**62.6%**	67.1%
Commission ratio	**11.2%**	9.1%
Expense ratio	**22.3%**	23.0%
Combined operating ratio	**96.1%**	99.2%
Adjusted earnings per share[5] – diluted (pence)	**25.0**	21.8
RoTE[2]	**16.0%**	11.5%
Pro forma RoTE[3]	**n/a**	13.4%

Key metrics – total Group		
Investment income yield	**2.1%**	2.0%
Investment return	**2.5%**	2.8%
Basic earnings per share (pence)	**20.9**	12.3
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0
Dividend per share		
– interim (pence)	**4.2**	4.0
– final (pence)	**8.4**	8.0
– regular (pence)	**12.6**	8.0
– first special (pence)	**4.0**	n/a
– second special (pence)	**4.0**	n/a
– total (pence)	**20.6**	8.0
– pro forma[6] regular (pence)	**n/a**	12.0

Performance

Operating profit – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Underwriting profit	**138.2**	28.2
Instalment and other operating income	**180.2**	198.3
Investment return	**208.1**	234.7
Operating profit	**526.5**	461.2

Overall operating profit from ongoing operations[1] of £526.5 million represented a 14.2% increase on 2012 (2012: £461.2 million). There was a significant improvement in the underwriting result, driven by higher than expected reserve releases of £435.1 million (2012: £322.0 million), in part due to management actions to improve the risk profile of the book and initiatives relating to claims, and despite poor weather in the last quarter, fewer claims from major weather events in Home in 2013. This more than offset a lower investment return, lower instalment and other operating income and higher than normal weather-related claims in Commercial and International.

In-force policies and gross written premium

In-force policies – ongoing operations (thousands)

As at 31 December	2013	2012
Motor	**3,762**	4,050
Home	**3,719**	4,239
Rescue and other personal lines	**8,801**	9,431
Commercial	**583**	466
International	**1,610**	1,462
Total ongoing	**18,475**	19,648

In-force policies for ongoing operations[1] decreased by 6.0% during 2013 to 18.5 million. The fall related primarily to Rescue and other personal lines and Home. The Rescue and other personal lines reduction arose mainly from travel policies from packaged bank accounts. Home in-force policies fell mainly as a result of the removal of Home Response[7] policies (around 420,000) from certain packaged bank accounts no longer sold through partners. Excluding this effect, which had little impact on gross written premium, Home in-force policies have decreased by 2.6% during 2013.

Notes:

1. See note 1 on page 2
2. See note 3 on page 2
3. See note 4 on page 2
4. Ongoing operations, adjusted for finance costs excluding gain on disposal of subsidiary and stated after charging tax (using the standard rate of 23.25%; (2012: 24.5%))
5. See note 6 on page 3
6. See note 5 on page 3
7. Insurance policy giving customers access to vetted tradesmen for home emergencies and repairs.

The fall in Motor in-force policies of 7.1% reflects the Group's focus on maintaining its underwriting discipline in a competitive marketplace, particularly for new business. The reclassification of van business to Commercial (around 70,000 in-force policies) from 1 January 2013 represented 1.7 percentage points of the reduction.

International growth arose from Germany where the Group has benefited from improved market conditions. Commercial continued to grow in-force policies, particularly in Direct Line for Business and also benefited from the reclassification of van business from Motor.

Gross written premium – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Motor	**1,421.1**	1,623.5
Home	**943.1**	989.0
Rescue and other personal lines	**383.4**	389.8
Commercial	**474.5**	435.6
International	**604.5**	552.7
Total ongoing	**3,826.6**	3,990.6

Gross written premium of £3,826.6 million fell 4.1% compared with the prior year (2012: £3,990.6 million). This reflects the impact of a competitive market, particularly in UK motor, together with the Group's continued focus on maintaining its underwriting discipline.

Gross written premium for Commercial of £474.5 million increased by 8.9% (2012: £435.6 million) due to the transfer of van business and growth in Direct Line for Business.

International gross written premium of £604.5 million was 9.4% higher than the previous year (2012: £552.7 million) as a result of strong growth in Germany more than offsetting subdued trading in Italy. Gross written premium in local currency terms increased by 4.9%, broadly in line with the growth of in-force policies.

Underwriting profit – ongoing operations

For the year ended 31 December	2013	2012
Underwriting profit (£ million)	**138.2**	28.2
Loss ratio	**62.6%**	67.1%
Commission ratio	**11.2%**	9.1%
Expense ratio	**22.3%**	23.0%
Combined operating ratio	**96.1%**	99.2%

The Group's COR for ongoing operations improved by 3.1 percentage points to 96.1% (2012: 99.2%), resulting in an increase in underwriting profit for ongoing operations to £138.2 million (2012: £28.2 million).

The improvement was primarily the result of a 4.5 percentage points reduction in the loss ratio. This arose from two main factors: significant reserve releases partly due to management actions to improve the risk profile of the book and initiatives relating to claims; and despite poor weather in the last quarter, fewer claims from major weather events in Home across the year. In 2013, the Home division incurred approximately £69 million of claims from major weather events (2012: approximately £105 million). This was partially offset by higher than normal weather-related claims in International (German hailstorms in June and July 2013) and in Commercial (storms and floods in the fourth quarter of 2013).

Current-year attritional loss ratio – ongoing operations

For the year ended 31 December	**2013**	2012
Reported loss ratio	**62.6%**	67.1%
Prior-year reserve releases	**12.4%**	8.7%
Major weather events – Home[1]	**(2.0%)**	(2.8%)
Current-year attritional loss ratio	**73.0%**	73.0%

The Group views the trend in the current-year attritional loss ratio as a good indicator of underlying performance as it excludes prior-year reserve movements and claims from major weather events in the Home division.

Overall, the current-year attritional loss ratio remained unchanged at 73.0% in 2013, despite competitive market conditions and higher than expected weather-related claims in International and Commercial.

Prior-year reserve releases – ongoing operations[2]

For the year ended 31 December	**2013**	2012
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

Overall prior-year reserve releases from ongoing operations increased to £435.1 million (2012: £322.0 million), equivalent to 12.4% of net earned premium (2012: 8.7% of net earned premium). Although the Group expects to continue to see significant reserve releases, the overall level experienced in 2013 is higher than would normally be expected. Assuming claims trends continue, a significant contribution from prior-year reserve releases is currently expected in 2014, albeit at a lower level than in 2013.

The commission ratio increased by 2.1 percentage points to 11.2% (2012: 9.1%), partly due to profit-share payments, reflecting the higher profitability of partnership business in the Home division. This is mainly attributable to fewer claims from major weather events.

The expense ratio improved 0.7 percentage points to 22.3% (2012: 23.0%), reflecting the benefits of cost reduction initiatives and reduced parallel running costs, but these benefits were partially offset by the effect of lower net earned premium.

Combined operating ratio by division – ongoing operations

	Reported basis	
For the year ended 31 December	**2013**	2012
Motor	**93.2%**	101.6%
Home	**93.8%**	96.6%
Rescue and other personal lines	**92.4%**	82.7%
Commercial	**106.8%**	108.2%
International	**103.9%**	103.3%
Total ongoing	**96.1%**	99.2%

On a segmental basis, the COR improved in Motor, Home and Commercial compared with 2012. Rescue and other personal lines COR increased in 2013 as positive one-off benefits in 2012 mainly from the creditor business were not repeated. The International COR remained broadly stable.

Current-year attritional loss ratio by division – ongoing operations

For the year ended 31 December	**2013 £m**	2012 £m
Motor	**85.3%**	85.4%
Home	**51.1%**	51.3%
Rescue and other personal lines	**62.5%**	57.2%
Commercial	**74.1%**	77.0%
International	**88.0%**	86.9%
Total ongoing	**73.0%**	73.0%

In Motor, the 8.4 percentage points improvement in COR reflects management actions to improve the risk profile of the book as well as higher releases of reserves from prior years. Reserve releases of £291.9 million in 2013 were driven primarily by favourable bodily injury experience for recent accident years, partly attributable to better risk selection and benefits arising from the Group's claims transformation programme. Assuming underlying claims trends continue, a significant contribution from prior-year reserve releases is currently expected in 2014, albeit at a lower level than in 2013. The current-year attritional loss ratio was in line with 2012.

Notes:

1. Home claims from major weather events, including inland and coastal flooding and storms.
2. This excludes Run-off segment reserve releases of £52.1 million (2012: £67.5 million).

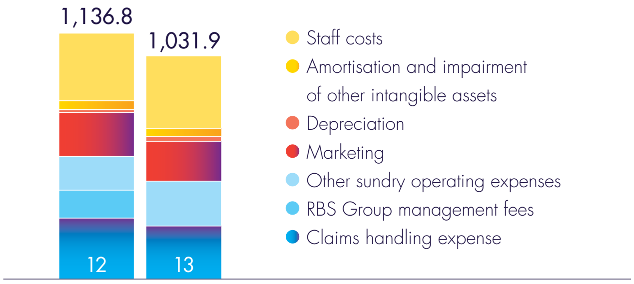
The Home COR improved to 93.8% in 2013 from 96.6% in 2012. The improvement was almost entirely driven by reduction in claims from major weather events. In 2013, claims from major weather events totalled approximately £69 million compared with approximately £105 million in 2012. The current-year attritional loss ratio was in line with the prior period, reflecting stable underwriting margins, albeit in a more competitive operating environment. Reserve releases were broadly in line with 2012.

The COR for Rescue and other personal lines increased to 92.4% (2012: 82.7%). The 2012 result benefited from positive one-offs (relating primarily to the run-off of the legacy creditor business) that were not repeated in 2013. The performance was also affected by higher claims frequency on the travel book and increased Green Flag marketing costs. The Life business, which contributed £6.4 million to operating profit in 2013 (2012: £8.1 million), was sold in November 2013.

The Commercial division improved its COR to 106.8% from 108.2% principally as a result of better underlying underwriting performance and a lower expense ratio. The current-year attritional loss ratio improved despite higher weather-related claims demonstrating the positive effect of recent management actions. The division continues to experience significant reserve releases. Excluding the impact of weather-related claims above normal levels, the COR would have been approximately 104%.

International COR in 2013 increased to 103.9% from 103.3% in 2012. The increase was due to claims relating to hailstorms in Germany in June and July. For 2013 as a whole, weather-related net claims were approximately £8 million more than expected. Reserve releases increased to £39.3 million (2012: £30.2 million) although are not expected to continue at these levels.

Total cost base[1]
(£m)



The expense ratio improved by 0.7 percentage points to 22.3% due to a reduction in operating expenses compared with 2012, partially offset by the impact of lower net earned premium.

Ongoing operating expenses of £786.4 million were reduced by 8.0% from the prior year (2012: £854.8 million). The reduction was principally due to the benefits from the Group's cost savings plan announced in 2012, tight cost control and the non-repeat of certain expenses under the historic RBS Group recharge.

From 1 July 2012, the Group no longer paid a management fee to RBS Group and this was replaced by directly paying third-party suppliers for the majority of services that RBS Group had previously provided. Consequently, expenses previously reported under management fees are now reflected within their relevant line items. The Group continues to pay RBS Group for transitional IT infrastructure, the costs of which are included within other operating expenses.

The Group is targeting a total cost base[1] of approximately £1,000 million in 2014 and the total cost base[1] in 2013 of £1,031.9 million showed good progress towards this target.

Instalment and other operating income – ongoing operations

For the year ended 31 December	**2013 £m**	2012 £m
Instalment income	**117.8**	125.4
Other operating income	**62.4**	72.9
Total ongoing	**180.2**	198.3

Breakdown of underlying other operating income – ongoing operations

For the year ended 31 December	**2013 £m**	2012 £m
Solicitors' referral fee income	**6.9**	21.1
Vehicle replacement referral income	**15.7**	17.2
Revenue from vehicle recovery and repair services[2]	**31.8**	25.9
Fee income from insurance intermediary services	**1.7**	1.9
Other income	**6.3**	6.8
Total ongoing	**62.4**	72.9

Instalment and other operating income from ongoing operations reduced by 9.1% from 2012. This was primarily as a result of the cessation of solicitors' referral fee income from 1 April 2013 and lower instalment income.

Instalment income, representing interest charged on insurance premiums paid by instalments, of £117.8 million reduced by £7.6 million compared with the prior year (2012: £125.4 million) as a result of lower in-force policies in Motor and Home and changes to business mix.

In February 2014, the Group sold its stolen vehicle recovery business, Tracker. In 2013, Tracker's revenue was £18.4 million (2012: £18.2 million) which was included in the above. Operating losses from the business were £1.4 million (2012: £3.9 million).

Notes:
1. See note 2 on page 2
2. Vehicle recovery includes post-accident and pay on use recovery and vehicle tracking. Repair services constitute the provision of non-insurance related services.

Investment return

For the year ended 31 December	Total Group 2013 £m	Total Group 2012 £m	Ongoing operations 2013 £m	Ongoing operations 2012 £m
Investment income	**188.6**	199.3	**175.5**	179.9
Net realised and unrealised gains	**32.5**	82.5	**32.6**	54.8
Total investment return	**221.1**	281.8	**208.1**	234.7

Investment yields – total Group

For the year ended 31 December	2013	2012
Investment income yield[1]	**2.1%**	2.0%
Investment return[2]	**2.5%**	2.8%

The total investment return reduced to £221.1 million compared with 2012, due to a decrease in realised gains and lower investment income resulting from lower AUM.

During 2013, the investment asset base decreased by 8.5% to £8.6 billion. Key reasons for the reduction include the repayment of the £258.5 million Tesco loan note and investment outflows resulting from a net reduction in insurance liabilities.

Investment income was £188.6 million, a 5.4% decrease on 2012, as a result of a lower average investment asset base, which was partially offset by an increase in investment income yields.

Net realised and unrealised gains recognised in 2013 were £32.5 million compared with £82.5 million in 2012. Realised gains in 2012 reflected significant portfolio restructuring actions. Total realised gains at 31 December 2013 were £58.8 million net of deferred tax (2012: £158.8 million).

The investment income yield on the total portfolio for 2013 was 2.1% (see page 41), an improvement on 2012 driven primarily by management actions to increase the credit and property weighting within the target investment mix.

Operating profit – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Motor	**347.7**	261.8
Home	**106.2**	93.3
Rescue and other personal lines	**46.5**	84.4
Commercial	**9.5**	2.2
International	**16.6**	19.5
Total ongoing	**526.5**	461.2

In the year ended 31 December 2013, all divisions were profitable, with all except Rescue and other personal lines and International improving profit versus 2012.

Notes:
1. Investment income yield excludes net gains
2. Investment return includes net gains

Reconciliation of operating profit

For the year ended 31 December	2013 £m	2012 £m
Ongoing operations	**526.5**	461.2
Run-off segment	**63.6**	6.1
Restructuring and other one-off costs	**(140.5)**	(189.5)
Total Group	**449.6**	277.8

Run-off
The Run-off segment made a profit of £63.6 million in 2013 compared with a profit of £6.1 million in 2012. Similar to the ongoing operations, the Run-off segment also benefited from higher prior-year reserve releases from the recognition of improved claims experience, in particular relating to large bodily injury claims. Going forward, it is currently expected that the Run-off segment will contribute positively to operating profit, albeit at a lower level than in 2013.

Restructuring and other one-off costs
Restructuring and other one-off costs for 2013 fell to £140.5 million (2012: £189.5 million) as a result of the non-repeat of costs associated with separation and divestment from RBS Group. This includes £60.2 million relating to IT migration and £80.3 million relating to the Group's cost saving initiatives. The Group currently expects that restructuring and other one-off costs in 2014 will be approximately £80 million.

Finance costs
Finance costs increased to £37.7 million (2012: £28.7 million), primarily reflecting a full year of interest on the £500 million of long-term subordinated debt issued in April 2012.

Gain on disposal of subsidiary
On 8 October 2013, the Group announced an agreement with Chesnara plc for the sale of the Life business. Total sale proceeds of £62.3 million, which include a pre-closing dividend of £23.0 million, represent 85% of the embedded value of the business at 30 June 2013. The sale completed on 28 November 2013 and the profit on disposal was £12.0 million.

Taxation
The Group has an important responsibility to its stakeholders to manage its tax position effectively to ensure that the Group is fully compliant with all laws and regulations; and to meet all its obligations as both a contributor of taxes and a collector of taxes on behalf of the tax authorities.

The effective tax rate for 2013 was 26.2% (2012: 26.0%) compared with the standard UK corporation tax rate of 23.25% (2012: 24.5%). This is driven primarily by earnings from the International operations which are subject to higher corporation tax rates, re-measurement of deferred tax asset, disallowable expenses, non-taxable disposal of subsidiary, and adjustments to provisions in respect of prior-year tax.

Profit for the year and return on tangible equity
Profit for the year amounted to £312.8 million (2012: £184.3 million), an increase of 69.7% on 2012.

RoTE from ongoing operations increased to 16.0% (2012: 11.5% and pro forma 13.4%) as a result of both the improved operating result and the capital actions taken to improve the efficiency of the Group's capital position.

Earnings per share

Basic earnings per share of 20.9 pence increased 69.9% (2012: 12.3 pence), reflecting the improved operating profit from ongoing operations and the Run-off segment, and a decrease in Restructuring and other one-off costs. Diluted earnings per share were 20.8 pence (2012: 12.3 pence).

Adjusted basic earnings per share, which excludes the Run-off segment, Restructuring and other one-off costs and gain on disposal of subsidiary, increased by 15.1% to 25.1 pence (2012: 21.8 pence). Diluted adjusted earnings per share were 25.0 pence (2012: 21.8 pence).

Dividends

The Board is proposing a final dividend of 8.4 pence per share making a total regular dividend for 2013 of 12.6 pence per share. This represents 5.0% growth over the pro forma[1] 2012 regular dividend and is in line with the Group's aim to grow dividends annually in real terms.

In addition, the Board is also declaring a further special interim dividend of 4.0 pence per share, in addition to the 4.0 pence per share paid in December 2013. This second special interim dividend reflects the better than planned performance in the Run-off segment and the proceeds from the recently announced sale of Tracker. Both these items are considered to be one-off in nature and as a result the Board believes it is appropriate in this instance to return this capital to shareholders.

Cash flow

Net cash used by operating activities before investment of insurance assets reduced to £307.0 million (2012: £966.0 million). This reflected a reduction of cash used by operations of £226.7 million (2012: £731.4 million) and reduction of taxes paid of £80.2 million (2012: £232.4 million). The reduction of cash used by operations resulted from an increase in trade and other payables and in payments of current and prior-year claims, partially offset by a decrease in insurance and other receivables.

Cash generated from investment of insurance assets reduced to £433.0 million in 2013 (2012: £2,004.8 million). Proceeds on the disposal and maturity of available-for-sale financial assets reduced to £3,147.8 million (2012: £4,021.6 million) and investment balances held with credit institutions decreased by £209.3 million (2012: £844.6 million). For 2012, amounts primarily reflected the funding of dividend payments to RBS Group of £1,000.0 million prior to the IPO, and investment portfolio restructuring.

Overall, net cash generated from operating activities totalled £126.0 million (2012: £1,038.8 million).

Net cash used by investing activities of £145.3 million (2012: £154.2 million), primarily comprised £115.5 million purchase of intangibles relating to ongoing software investment (2012: £96.6 million).

Dividends paid amounted to £242.7 million (2012: £1,000.0 million) with the 2012 balance representing payment of dividends to RBS Group prior to the IPO. The Group repaid borrowings during the year representing the Tesco loan note of £258.5 million with the 2012 repayment (£246.4 million) representing loans with RBS Group. Following these, net cash used by financing activities totalled £544.7 million (2012: £774.5 million).

Note:

1. See note 5 on page 3

Overall, cash and cash equivalents decreased by £564.0 million (2012: £110.1 million increase) across the year to £853.2 million (31 December 2012: £1,417.5 million) representing the rebalancing of the investment portfolio including the reduction of cash holdings.

Net asset value

For the year ended 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
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0

The net asset value at 31 December 2013 was £2,790.0 million (31 December 2012: £2,831.6 million) with tangible net asset value of £2,289.9 million (31 December 2012: £2,410.1 million). This equates to 186.6 pence and 153.2 pence per share respectively as at 31 December 2013 (31 December 2012: 189.1 pence and 161.0 pence, respectively).

The reduction in net asset value and tangible net asset value principally reflects the payment of the final 2012, interim and first special interim 2013 dividends, a reduction in the level of unrealised gains in the debt securities portfolio, and increased investment in intangible assets offset by profit for the period.

Significant accounting policies

Except as disclosed in note 1 to the consolidated financial statements, the same accounting policies and basis of recognition and measurement have been followed in the consolidated financial statements as applied in the Group's previous annual audited financial statements for the year ended 31 December 2012.

Where new or revised standards have been adopted in the year, these have not had a material impact on the Group's financial statements.

Financial management

The Group's long-term sustainability depends on having sufficient funds to meet its liabilities as they fall due. This protects the reputation of its brands and the integrity of the Group's relationship with customers and other stakeholders. The principal financial risks that are present in the Group are reserving, market risk connected to the investment portfolio and counterparty risk.

Reserving

Estimation of claims reserves is a central aspect of financial management. Insurance is inherently uncertain, requiring the use of judgement in estimating the ultimate claims liability. The factors that must be considered when assessing the level of outstanding liabilities include class of business, timeliness of notification of claims, validity of claims made against a policy and validity of the amount of the claim. At any time there is a range of possible outcomes at which the claims reserves could ultimately settle and, as time passes, the uncertainty surrounding likely claims settlement reduces. The uncertainty is greater for bodily injury claims due to the time it takes for these claims to settle. This is particularly true for PPOs awarded to settle some bodily injury claims, in which annually indexed payments could be awarded over the lifetime of the injured party.

Given this uncertainty, the Group adopts a conservative approach to the assessment of liabilities. This conservative approach is supported by historical claims reserve releases. These can be observed in the gross and net ultimate claims cost development triangles shown on pages 153 and 154. The triangles demonstrate that, for all accident years, the estimated ultimate claims cost has reduced over time from the year of first validation. Reductions in ultimate claims cost have fluctuated over the period, with the accident years from 2003 to 2006 and 2010 showing the largest decreases. The 2009 accident year has shown the lowest reduction; this followed a significant increase in claims relating to motor over the 2009 and 2010 financial years, in response to the market-wide adverse development in bodily injury claims. This resulted in part from the rise of claims management companies, an increase in no-win no-fee litigation, and an increase in the number of PPOs.

Actuarial reviews are carried out quarterly, with over 95% of all claims reserves being reviewed at least annually. Actuarial best estimates are produced internally, and are subject to independent external review at least annually. Reserves are based on management's best estimate set by the Group, which will be at least equal to the actuarial best estimate at a legal entity level. The Group will set reserves informed by a range of actuarial outputs including percentiles and scenarios. It will consider the level of historical variability inherent in the claims data and other short- and long-term risks not reflected in the actuarial data.

Claims reserves net of reinsurance

For the year ended 31 December	2013 £m	2012 £m
Motor	**2,606.3**	3,026.6
Home	**398.1**	403.8
Rescue and other personal lines	**77.4**	77.1
Commercial	**637.9**	588.3
International	**438.2**	429.7
Total ongoing operations	**4,157.9**	4,525.5
Run-off segment	**682.2**	856.4
Total Group	**4,840.1**	5,381.9

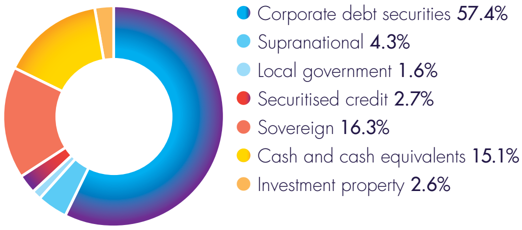
Investment portfolio

The Group's investment portfolio comprises primarily of investments in sovereign debt securities, investment grade fixed income securities and cash. The strategy ensures adequate liquidity is always available to meet customers' claims, particularly in periods of stress (for example, natural disasters). It is also designed to ensure that asset and liability durations match closely where possible; and that risk is diversified and return maximised relative to the Group's risk appetite and capital allocated to investment risk.

During 2013, key achievements included:

- Undertaking a major asset and liability management study on U K Insurance Limited, which reconfirmed liquidity requirements and proposed some changes to the current asset mix to deliver a better overall risk adjusted return
- Transferring the management of 'AAA' fixed-income credit in-house to improve the overall cost effectiveness of the operating model
- Increasing the benchmark allocation to investment grade credit and the sub-allocation to 'BBB' rated assets
- Investing into externally managed securitised credit, with the focus on investment into the highest-quality debt tranches and having a well-diversified range of collateral types and pools backing such investments
- The continuing selective purchase of assets for the UK commercial property portfolio. The asset brings portfolio return diversification and long-term returns to support inflation-linked liabilities

Investment portfolio as at 31 December 2013
(%)



Investment portfolio as at 31 December 2012
(%)

Derivatives are permitted for risk management purposes within the investment portfolio. These include interest rate swaps to change the liability to a floating basis on the debt issuance and US Dollar credit mandates and forward currency contracts to manage currency risk.

Total debt securities are £7,045.3 million (2012: £7,164.3 million), of which 12.9% are rated as 'AAA' and a further 70.5% are rated as 'AA' or 'A'. Corporate, local government and supranational debt securities account for 63.2% of the portfolio.

The total value of the investment portfolio as at 31 December 2013 was £8,557.6 million, 8.5% lower than as at 31 December 2012. AUM provide adequate access to liquidity, with 15.1% of the funds held in cash and cash equivalents at the year end.

The duration as at 31 December 2013 of total investment assets was 2.0 years, with the breakdown being: UK 1.9 years; Italy 3.3 years; and Germany 2.4 years (2012: 1.8 years; UK 1.7 years; Italy 2.8 years; and Germany 2.5 years).

The internally managed gilt and 'AAA' credit portfolios have intentionally been held at a shorter duration than benchmark given the expectation of improvements in the interest rate environment. In addition, to minimise further interest rate risk the Group has increased its investment allocation to floating rate instruments, for example securitised credit. The US credit portfolios have been swapped to a floating basis since inception in 2012.

Investment property holdings shown as at 31 December 2013 comprised 20 properties. The primary sector exposures are industrial warehouses (26.5%) and supermarkets (19.7%).

Asset and liability management

Asset and liability management influences the Group's investment strategy through the matching of assets and liabilities, for further information please see the table below:

	Liabilities	Asset	Characteristics
Long term >10 years	PPOs	Property, infrastructure debt[1]	Inflationary linked or floating
Short and medium term	All other claims	Investment grade credit	Key rate duration matched
Debt	Tier 2 sub debt (swapped fixed to floating)	Securitised credit and cash	Floating
Surplus	Tangibles	Investment grade credit, cash and government debt securities	Fixed or floating

Note:

1. Infrastructure debt is a new asset class which the Group plans to invest in 2014.

Asset allocation and benchmarks

	UK			Germany			Italy		
	Current benchmark holding	**2013 Year end**	2012 Year end	Current benchmark holding	**2013 Year end**	2012 Year end	Current benchmark holding	**2013 Year end**	2012 Year end
Credit[1]	63%	**63%**	54%	88%	**81%**	67%	100%	**100%**	93%
Securitised credit[2]	6%	**2%**	–	12%	**19%**	17%	–	**–**	–
Sovereign	19%	**18%**	21%	–	**–**	8%	–	**–**	–
Total debt securities	**88%**	**83%**	75%	**100%**	**100%**	92%	**100%**	**100%**	93%
Cash[3,4]	7%	**14%**	23%	Min €35m	**€61m**	8%	Min €45m	**€47m**	7%
Investment property	5%	**3%**	2%	–	**–**	–	–	**–**	–
Total	**100%**	**100%**	100%	**100%**	**100%**	100%	**100%**	**100%**	100%

Asset studies for the UK portfolio resulted in the introduction of securitised credit as a new asset class in 2013. The benchmark holding for fixed income credit was increased during the year from 60% to 63%. Further investment properties were acquired during the year to bring the holding closer to the allocated level. Following an asset liability management review, the Group plans to start investing into infrastructure debt in 2014.

Investment holdings and yields – total Group

	2013		2012	
As at 31 December	**Asset allocation**	**Income**	Asset allocation	Income
Corporate debt securities[5]	**4,915.8**	**128.7**	4,483.4	121.9
Supranational	**365.7**	**6.5**	521.8	8.8
Local government	**134.5**	**2.9**	271.1	2.7
Credit	**5,416.0**	**138.1**	5,276.3	133.4
Securitised credit[5]	**229.8**	**1.1**	45.2	3.4
Sovereign	**1,399.5**	**30.7**	1,842.8	38.8
Total debt securities	**7,045.3**	**169.9**	7,164.3	175.6
Cash and cash equivalents[6]	**1,288.9**	**7.3**	2,062.5	19.3
Investment property	**223.4**	**11.4**	128.9	4.4
Total Group	**8,557.6**	**188.6**	9,355.7	199.3
Corporate debt securities[5]	**57.3%**	**2.7%**	47.9%	2.9%
Supranational	**4.3%**	**1.5%**	5.6%	1.7%
Local government	**1.6%**	**1.5%**	2.9%	1.4%
Credit	**63.2%**	**2.6%**	56.4%	2.7%
Securitised credit[5]	**2.7%**	**0.8%**	0.5%	2.1%
Sovereign	**16.4%**	**1.9%**	19.7%	1.6%
Total debt securities	**82.3%**	**2.4%**	76.6%	2.4%
Cash and cash equivalents[6]	**15.1%**	**0.4%**	22.0%	0.8%
Investment property	**2.6%**	**6.5%**	1.4%	4.4%
Total Group	**100.0%**	**2.1%**	100.0%	2.0%

Notes:

1. Credit in Italy allows a maximum holding of €25.0 million of Buoni del Tesoro Poliennali, Italian government debt securities and as at 31 December 2013 this stood at £24.1 million.
2. Pfandbrief holdings in the German portfolio are overweight as a result of legacy holdings, which are in the process of being run down.
3. Awaiting investment into securitised credit and property (UK)
4. During the year the cash holdings for the International business was set to a minimum holding for liquidity purposes rather than as a percentage of AUM.
5. Asset allocation at 31 December 2013 includes investment portfolio derivatives, which have been netted and have a mark-to-market value of £39.8 million, split £37.7 million in corporate debt securities and £2.1 million in securitised credit (31 December 2012: £7.8 million in corporate debt securities).
6. Net of bank overdrafts and including term deposits with financial institutions with maturities in excess of three months.

Capital management

Capital management policy

The Group seeks to manage its capital efficiently, maintaining an appropriate level of capitalisation and solvency, while aiming to grow its dividend annually in real terms.

In determining the appropriate level of capitalisation and solvency the Group considers capital on a number of metrics, including risk-based capital, regulatory capital and rating agency capital. The Group targets holding capital in the range of 125% to 150% of risk-based capital and holding capital sufficient to maintain a credit rating in the 'A' range.

Where the Board believes the Group has capital which is surplus to requirements, for example if it had an expectation that the risk-based capital coverage would be significantly above the 125% to 150% target range for a prolonged period, it would look to return capital to shareholders.

Risk-based capital

For its principal UK general insurance underwriter, U K Insurance Limited ("**UKI**"), the Group uses its own risk-based capital model to determine the level of capital required to operate within its risk appetite. The internal model is calibrated to a 99.5% confidence interval and considers both earned business and future business written over a one-year period. Furthermore, the model allows for uncertainty on this business until ultimate settlement. This approach is consistent with the ICA methodology set by the PRA.

For UKI, the major part of its required capital is held against reserve risk (approximately 46%) followed by underwriting risk (approximately 27%) and operational risk (approximately 13%). The high level of reserve risk reflects the size of the claims reserves still held against business written when the Group's premium base was larger, including the Run-off segment, and the Group's exposure to PPOs which carry a high capital requirement.

Capital allocated by risk type – U K Insurance Limited (%)

The Group's International entities, in Italy and Germany, hold capital in excess of that required by their local regulators.

Current capital position and outlook

The Board considers the Group is currently strongly capitalised with a risk-based capital coverage ratio at the upper end of its risk-based capital coverage target range and an 'A' rating with stable outlook from its credit rating agencies.

In determining this position, the Board has considered a number of factors that may positively and negatively affect the Group's capital position over the next 12 months. In particular, the Group's UK regulated general insurance underwriters are currently going through the new ICAS+ process with the PRA to assess the Group's future individual capital guidance. The ICAS+ process will also enable firms to obtain feedback on their progress towards Solvency II. This process is more involved than previous years and includes a detailed assessment of the Group's internal risk-based capital model. In addition, the introduction of Solvency II from 2016 and changes to capital requirements and reporting are still being confirmed, especially in the area of long-term guarantees.

During 2013, the Group updated its investment target asset mix and in 2014 is developing further its asset and liability management solutions for longer tail insurance liabilities. This includes investing in infrastructure debt. As these changes take affect, it is expected that there will be an increase in the capital allocated to market risk. Furthermore with current bond yields remaining low, the Group expects to continue to see its level of unrealised bond gains reduce as bonds mature and are reinvested.

The Group continues to invest in its operations and is likely to see an increase in intangible assets that may not qualify fully towards the Group's capital base.

Taken together the Board believes that it is appropriate to maintain capital at the upper end of its risk-based capital coverage range. The Board will continue to review this position as clarity improves on the factors mentioned above and the Group makes further progress on its transformation plan.

Dividends

In relation to 2013, the Group has paid, or is recommending, dividends amounting to £308.7 million and 20.6 pence per share. This consists of a regular dividend of 12.6 pence per share, representing 5.0% growth on the pro forma 2012 full year dividend, and two special interim dividends totalling 8.0 pence per share. The regular dividend is consistent with the Group's policy to aim to raise dividends annually in real terms.

The two special interim dividends relate to specific items in 2013 that the Board considers to be one-off in nature – the disposal of its closed Life business and the higher than planned profit in the Run-off segment. Total dividends are equivalent to 98.6% of post-tax profit. The regular dividend represents 50.4% of post-tax profit from ongoing operations.

Capital position and leverage

The Group is well capitalised with key capital metrics within the Group's risk appetite and significantly above regulatory minima.

As at 31 December	2013 £m	2012 £m
Consolidated statutory solvency capital		
Shareholders' equity	**2,790.0**	2,831.6
Goodwill and other intangible assets	**(500.1)**	(421.5)
Regulatory adjustments	**6.2**	(73.5)
Total Tier 1 capital	**2,296.1**	2,336.6
Lower Tier 2 capital[1]	**496.9**	495.5
Regulatory adjustments	**(28.9)**	(23.7)
Total regulatory capital	**2,764.1**	2,808.4
Insurance Group Directive ("IGD")		
IGD required capital[2]	**947.9**	1,005.0
IGD excess solvency	**1,816.2**	1,803.4
IGD coverage ratio	**291.6%**	279.4%
Risk-based capital coverage ratio	**158.7%**	151.4%
Risk-based capital coverage ratio (adjusted for final and second special interim dividends)	**148.7%**	145.4%

Notes:

1. Includes that element of the subordinated dated notes applicable for regulatory capital purposes.
2. Based on the IGD for the Group and 2012 adjusted to include the capital requirement for Direct Line Versicherung AG acquired on 2 April 2012.

The above regulatory numbers are estimated, based on preliminary regulatory returns for 31 December 2013.

At 31 December 2013, the Group had an estimated risk-based capital coverage ratio of 158.7% (31 December 2012: 151.4%) which reduces to 148.7% after deducting the recommended final and second special interim dividends (31 December 2012: 145.4%). On an IGD basis, the coverage is 291.6% (31 December 2012: 279.4%).

The table below sets out the Group's financial leverage ratio:

As at 31 December	2013 £m	2012 £m
Shareholders' equity	**2,790.0**	2,831.6
Undated subordinated loan[1]	**–**	258.5
Subordinated dated notes	**486.6**	529.0
Total financial debt	**486.6**	787.5
Total capital employed	**3,276.6**	3,619.1
Financial leverage ratio[2]	**14.9%**	21.8%

Notes:

1. Repaid in January 2013. Following the repayment of the undated subordinated loan, the financial leverage ratio on a pro-forma basis, excluding the undated subordinated loan, as at 31 December 2012 would have been 15.7%.
2. Total financial debt as a percentage of total capital employed.

The Group's leverage ratio remains conservative with a financial leverage of 14.9% at 31 December 2013 (31 December 2012: 21.8%). The main change during 2013 was the repayment of the Tesco loan note in January. Excluding this the leverage ratio at 31 December 2012 would have been 15.7%.

Credit ratings

Standard & Poor's and Moody's Investors Service provide insurance financial strength ratings for U K Insurance Limited, the Group's principal UK general insurance underwriter. U K Insurance Limited is currently rated 'A' (strong) with a stable outlook by Standard & Poor's and 'A2' (good) with a stable outlook by Moody's.