SCOTTISH AMICABLE FUNDS

Annual Report and Financial Statements for the Year Ended 31 December 2012

SCOTTISH AMICABLE FUNDS

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Scottish Amicable Board

Bernard Solomons (Chairman)
Finbar O'Dwyer
Paul Dollman
Brian Medhurst
Michael Walker

Secretary to the Board

Susan Windridge

Auditors

KPMG Audit Plc, London

REPORT OF THE SCOTTISH AMICABLE BOARD FOR THE YEAR ENDED 31 DECEMBER 2012

Background

Under the terms of the Scheme for the transfer of the business of the Scottish Amicable Life Assurance Society to The Prudential Assurance Company Limited (the Scheme) on 30 September 1997, The Prudential Assurance Company Limited (PAC) is required to produce for each financial year reports and accounts of the Scottish Amicable Funds (the Funds) as if they together constituted an authorised insurance company in accordance with the Financial Services and Markets Act 2000 (and, where necessary, the laws and regulations of any other jurisdiction) and generally accepted accounting practices and policies, and to have them audited by the auditors of PAC. The Funds comprise the Scottish Amicable Insurance Fund (the Fund), which is a closed fund, and the Scottish Amicable Capital Fund (the Capital Fund). The Scottish Amicable Insurance Fund receives financial support from the Scottish Amicable Capital Fund, and it protects the solvency position of the Scottish Amicable Insurance Fund.

In order to safeguard the ongoing interests of policyholders whose policies were transferred into the Fund, the Scheme established a special committee called the Scottish Amicable Board, with responsibility for the management (including investment and bonus policy) of the Funds.

Scope of report

This report comprises a profit and loss account and balance sheets for the Scottish Amicable Funds for the year ended 31 December 2012 together with explanatory notes.

Business Review

Principal Activity

In accordance with the terms of the Scheme governing the transfer of business, certain business has continued to be written in the Fund, which is a closed fund. This business is primarily in respect of increments to existing policies written by Scottish Amicable Life Assurance Society prior to 1 October 1997. New premiums for the year comprise £21.3m (2011: £22.8m) of single premiums, which are included in total premiums of £140.0m (2011: £169.2m).

The Fund is a sub-fund of PAC which is a wholly owned subsidiary undertaking of another company registered in England and Wales and therefore group financial statements and a group business review are not prepared. Accordingly, the financial statements and this business review present information about the Fund as an individual undertaking and are not consolidated.

The Fund's long-term products consist of life insurance, pension products and pension annuities. In common with other UK long-term insurance companies, the Fund's products are structured as either with-profits (or participating) products, or non-participating products including annuities in payment and unit-linked products. With-profits policies are supported by the with-profits sub-fund and can be single or regular premium. With-profits policyholders currently receive 100 per cent of the distribution from the Fund as bonus additions to their policies.

Risks & Uncertainties

As a provider of insurance services, the Fund's business is the managed acceptance of risk. The Company the Fund is part of is a wholly owned subsidiary of the Prudential Group and is subject to the Group's internal control and risk management processes as detailed in the Group Governance Manual and Group Risk Framework. The control procedures and systems established within the Group are designed to manage, rather than eliminate, the risk of failure to meet business objectives. They can only provide reasonable and not absolute assurance against material misstatement or loss, and focus on aligning the levels of risk-taking with the achievement of business objectives.

The Group's risk and governance framework requires all businesses and functions within the Group, including the Fund, to establish processes for identifying, evaluating and managing key risks. The risk management framework for the Fund is approved by the Board and operates based on the concept of three lines of defence: risk management, risk oversight and independent assurance.

The Fund's results and financial condition are exposed to both financial and non-financial risks from its long-term with-profits and non-profits business. The key risk factors, mentioned below, should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

Financial risks

The Fund is exposed to financial risk through its financial assets, financial liabilities, and policyholder liabilities. The financial risk factors affecting the Fund include market risk, credit risk, insurance risk and liquidity risk. Further information on the financial risk management objectives and policies of the Fund and the exposure of the Fund to the financial risk factors is given in note 17 on page 26.

The current uncertainty in local and international economic and investment climates has increased financial risks and this could adversely affect the Fund's business. Since 2008 the Fund has had to operate against a challenging background of periods of unprecedented volatility in global capital and equity markets, interest rates, liquidity, and the broader economic environment. Government interest rates have also fallen to historic lows in the US and the UK.

In recent times, the global financial markets have experienced further volatility brought on, in particular, by concerns over European sovereign debt, as well as concerns about a general slowing of global demand reflecting an increasing lack of confidence among consumers, companies and governments. Upheavals in the financial markets may affect general levels of economic activity, employment and customer behaviour. For example, insurers may experience an elevated incidence of lapses, or surrenders of policies, and some policyholders may choose to defer or stop paying insurance premiums. The demand for insurance products may also be adversely affected. New challenges related to market fluctuations and general economic conditions may continue to emerge.

(a) Market risk

Market risk is the risk of loss for the Fund, or of adverse change in the financial situation, resulting directly or indirectly, from fluctuations in the level and/or volatility of market prices of assets and liabilities and changes in interest rates and exchange rates.

Market risk is one of the largest risks for the Fund. The current uncertainty in local and international economic and investment climates has increased market risk and this could adversely affect the Fund's business principally through the following:

Investment impairments or reduced investment returns, as a result of market volatility, could impair the Fund's ability to meet its policyholder liabilities.

(b) Credit risk

Credit risk is the risk of loss to the Fund resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors in the form of default or other significant credit event (e.g. downgrade or spread widening).

The Fund is exposed to significant credit risk which is also one of the largest risks for the Fund. The credit risk arises mainly from the corporate bond holdings in the non-profit annuity and with-profits business. The global financial crisis has exacerbated credit risk as corporate borrowers are experiencing a challenging business environment and volatile profits and cashflows. This has impacted credit risk through the following:

Increased risk of credit losses through defaults and widening of credit spreads on corporate bonds. This is a material risk for the Fund and is managed by careful management of the corporate bond portfolio and having appropriate concentration and credit rating limits in place.

The Fund, in the normal course of business enters into a variety of transactions with counterparties, including reinsurance and derivative transactions. Failure of any of these counterparties to discharge their obligations, or where adequate collateral is not in place (eg in case of reinsurance counterparties), could have an adverse impact on the Fund's results. The Fund manages reinsurance counterparty risk by diversifying its reinsurance exposures across a number of counterparties, and by having minimum counterparty credit rating limits and maximum concentration limits in place. Derivative counterparty risk is largely mitigated by careful counterparty selection and adequate collateralisation arrangements.

(c) Insurance risk

Insurance risk is the risk of loss or of adverse change in the value of insurance liabilities of the Fund , resulting from changes in the level, trend or volatility of a number of insurance risk drivers. This includes adverse longevity, mortality, morbidity, persistency and expense experience.

The Fund is exposed to significant insurance risk which is also one of the largest risks for the Fund. Insurance risk arises mainly from the annuity business in the form of longevity risk, which is the risk that the Fund's (current and deferred) annuity customers live longer than expected in the Fund's current pricing and reserving assumptions and as a result future reserving and capital assumptions are changed. The Fund conducts rigorous research into longevity risk, using data from its annuitant portfolio. As part of its pension annuity pricing and reserving policy, the Fund assumes that current rates of mortality continue to improve over time at levels based on the Fund's calibration of the Continuous Mortality Investigations (CMI) 2011 mortality projection model as published by the Institute and Faculty of Actuaries. If mortality improvement rates significantly exceed the improvement assumed, the Fund's operating results could be adversely affected. Also any major medical breakthrough (for example in the treatment of cancer or other life-threatening diseases) that would require the Fund to strengthen its longevity assumptions will have an impact on the Fund's results.

The other insurance risks run by the Fund are expense risk, persistency risk and mortality/morbidity risk. These risks are less material than the market, credit and longevity risks.

Expense risk is the risk of the actual expenses exceeding the assumptions in pricing and reserving and is relevant to all lines of business. The Fund makes assumptions about future expected levels of expenses for each line of business and uses these in pricing and calculating reserves. If the actual expenses exceed these assumptions, the Fund's results could be adversely impacted.

Persistency is the assumption that the Fund makes about future expected levels of the rates of early termination of products by its customers. The Fund's persistency assumptions reflect the recent past experience for each relevant line of business including any expected trends in future persistency rates. If the actual levels of future persistency are significantly lower than assumed (that is, policy termination rates are significantly higher than assumed), the Fund's results of operations could be adversely affected. This risk is only relevant to the non-annuity business in the Fund.

Mortality and morbidity risks relate to assumptions around the expected number of deaths or illnesses used in calculating reserves. These are relevant for those lines of business where the customer payoff is dependant on a death or illness. An example is the impact of epidemics or other events that cause a large number illnesses and/or deaths. Significant influenza epidemics have occurred three times in the last century, but the likelihood, timing, or the severity of future epidemics cannot be predicted. The effectiveness of external parties, including governmental and non-governmental organisations, in combating the spread and severity of any epidemics could have a material impact on the Fund's loss experience. If the actual mortality or morbidity rates are significantly higher than those assumed in pricing and reserving, then the Fund would make a loss on certain lines of business which could be offset by potential gains on other line of business due to the natural diversification between longevity and mortality risks.

In common with other industry participants, the profitability of the Fund's businesses ultimately depends on a mix of factors including investment performance and impairments, mortality and morbidity trends, policy surrender rates and unit cost of administration.

(d) Liquidity risk

Liquidity risk is the risk that the Fund, although solvent on a balance sheet basis, does not have sufficient cash resources available to meet its obligations as they fall due, or can secure them only at excessive cost.

Liquidity risk is not a material risk for the Fund. This risk is managed through careful management of bank balances, cash-flow forecasting and appropriate fund management (to ensure that assets are not unduly concentrated in less liquid investments). As a result the Fund has substantial volumes of readily realisable assets.

Non-financial risk

The Fund is exposed to business environment, operational and group risk.

(a) Business environment risk

Business environment risk is the exposure to forces in the external environment that could significantly change the fundamentals that drive the Fund's overall strategy.

The Fund conducts its business subject to regulation and the associated regulatory risks, and is therefore exposed to changes in laws, and regulations that affect the products and markets in which it operates.

Changes in government policy, legislation (including tax) or regulatory interpretation applying to UK insurance companies may be applied retrospectively, may adversely affect the Fund's product range, capital requirements and, consequently, reported results and financing requirements. Regulators may change the level of solvency capital required to be held or could introduce possible changes in the regulatory framework for pension arrangements, retirement income and investments, or the regulation of solvency requirements.

The material regulatory and legal change risks currently faced are:

- Solvency II - The EU is harmonising the solvency framework for insurance companies across Europe based on the concept of three pillars — minimum capital requirements, supervisory review of firms' risk management system, and enhanced disclosure requirements. This will cover valuations, the treatment of insurance groups and companies, the definition of capital and the level of capital required. A key aspect of Solvency II is that the assessment of risks and capital requirements will be aligned more closely with economic capital methodologies, and may allow the Fund to make use of its internal economic capital models, if approved by the relevant supervisory authority. Although the Solvency II Directive was formally approved by the Economic and Financial Affairs Council in November 2009 the Solvency II implementation date has been postponed from 1st January 2014 and the new date is yet to be confirmed. Discussions are on-going within the European Parliament, the European Commission and the Council for the European Union to agree the Omnibus II Directive and to develop the detailed rules that will complement the high-level principles of the Directive, referred to as 'implementing measures'. Agreement to the Omnibus II Directive is not currently scheduled to be finalised until late 2013 while the implementing measures cannot be finalised until after Omnibus II. There is significant uncertainty regarding the final outcome of this process. As a result there is a risk that the effect of the measures finally adopted could be adverse for the Company, including potentially a significant increase in capital required to support its business and that the Company may be placed at a competitive disadvantage to other European and non-European financial services groups;

- The split of regulation in the UK in 2013 between the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) may give rise to new requirements and risks for the Fund;
- Any further changes or modification to Financial Reporting Standards, or adoption of International Financial Reporting Standards (IFRS) may require a change in the reporting basis of future results, or a restatement of reported results;
- Changes in tax legislation could affect the Fund's financial condition.

(b) Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.

The Fund is exposed to operational risk in the ordinary course of its business and as a result may be subject to unplanned costs, regulatory fines or legal actions and disputes in relation to contracts or a course of conduct taken. These legal actions and disputes may relate specifically to the Fund's businesses and operations or may be issues that are common to companies that operate in the Fund's markets. Although the Fund believes it has adequately provisioned for the potential costs of litigation and regulatory matters, no assurance can be provided that such reserves are sufficient. Given the large or indeterminate amounts of damages sometimes sought, and the inherent unpredictability of litigation and disputes, it is possible that an adverse outcome could, from time to time, have an adverse effect on the Fund's results of operations or cash flows.

The Fund operates in a mature and highly regulated environment where the pace of regulatory change has intensified making regulatory compliance a key risk. There has been an increase in fines and regulatory sanctions imposed on firms.

The Fund's activities involve processing a large number of complex transactions across numerous and diverse long term insurance products. As a result it is exposed to the risks of data integrity and transaction processing errors. The Fund's operating model is to outsource several activities both intra-group and externally, including investment management, a significant part of its customer-facing functions as well as some IT functions. The Fund is therefore reliant upon the operational processing performance of its outsourcing partners, and their performance is monitored carefully.

Further, because of the long-term nature of much of the Fund's business, accurate records have to be maintained securely for significant periods.

The Fund's systems and processes incorporate controls which are designed to manage and mitigate the operational risks associated with its activities as any weakness in the administration and finance systems and reserving processes could impact operations or the results. The Fund has not identified any operational risk events in 2012, which have subsequently caused, or are expected to cause, a significant negative impact on its results of operations.

(d) Group risk

Group risk is the risk associated with being part of a group, particularly as a result of contagion.

Being a member of a group can provide significant advantages for the Fund in terms of diversification of risk, financial strength, technical expertise and management experience. It can also give rise to risks; if a guarantee of financial support given by the parent were removed, or from particular transactions arising from an impaired parent or affiliate within the group. The independent capitalisation of the Fund as well as the risk management processes and internal control mechanisms within the Fund ensure group risk is appropriately managed.

Performance and Measurement

The Fund's delivered a positive investment return of 10.1% in 2012 (2011: 3.9% return). Much of this investment performance was achieved through the very diversified nature of the fund. As part of its asset allocation process, the fund managers constantly evaluate prospects for different markets and asset classes.

Corporate Responsibility

The Funds are part of PAC, a wholly owned subsidiary within the Prudential Group and Corporate Responsibility (CR) is integral to the way the Group does business.

The Group, of which the Funds are a part, has developed a Group Governance Framework which is underpinned by a Group Governance Manual and associated processes. This encompasses all key policies and procedures for example, the Group Code of Business Conduct.

As a business that provides savings, income, investment and protection products and services the Group creates social value through its day-to-day operations. First, the Group provides customers with ways to help manage uncertainty and build a more secure future. Second, by playing a key role in financial markets, the Group provides long-term capital that finances businesses, builds infrastructure and fosters growth in both developed and developing countries.

The Group aims to be sustainable in the broadest sense – financially, socially and environmentally. Sustainability is integral to the way it does business. Prudential has long-term liabilities and investments, and its commitments to its customers and its employees, as well as its support for communities and its responsibility towards the environment, are rooted in its aim of continuing to deliver strong financial performance sustainably.

The Group believes that CR is best managed on the ground by those closest to the customer and local stakeholders. Underpinning this approach are the Group's four global CR themes:

1. Customers: Using the Group's financial strength, knowledge and skills to provide fair and transparent products, which meet customers' needs;
2. People: Recruiting, developing and retaining the best people for the best-performing business;
3. The environment: Increasing the efficiency of the Group's business by reducing the direct impact of the properties it occupies and the properties it manages as part of its investment portfolio;
4. Communities: Supporting its communities through donations, employee volunteering and long-term partnerships with charitable organisations that make a real difference.

These themes demonstrate the Group's CR commitments and principles to its stakeholders and provide clarity to its businesses, including the Funds, on where they should focus their CR efforts and resources in the context of their individual markets.

The Prudential plc Board discusses the Group's CR performance at least once a year and also reviews and approves the Group CR Report and strategy on an annual basis. Below Board level, the Responsibility Committee comprises senior representatives from the relevant Group functions and each of its core businesses. This committee is responsible for monitoring the Group's CR activities and reviewing CR policies.

Payment policy

It is the policy of the Fund to agree terms of payment when orders for goods or services are placed and to pay in accordance with those terms. This policy was strengthened in 2009 by signing up to the Prompt Payment Code, launched in December 2008 by the UK Department for Business, Enterprise and Regulatory Reform. In 2012, the Fund's trade creditor days, based on the ratio of amounts which were owed to trade creditors at the year end to the aggregate of the amounts invoiced by trade creditors during the year, were 22 days (2011: 22 days).

Scottish Amicable Board members

The present members of the Scottish Amicable Board, all of whom held office throughout the year, are shown on page 2. On 31 December 2012, Niamh Duddy resigned as Secretary to the Board and Susan Windridge was appointed as Secretary to the Board in her stead.

Post balance sheet events

There have been no significant events affecting the Fund since the balance sheet date.

Statement of Directors' Responsibilities

Pursuant to its responsibility, in relation to the preparation of reports and accounts of the Scottish Amicable Funds, PAC requires another Prudential Group company, Prudential Distribution Limited (PDL), to prepare financial statements for the Funds in accordance with the requirements of the Scheme. The directors of PDL have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

The directors of PDL must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Funds and of the profit or loss of the Funds for that period. In preparing these financial statements, the directors of PDL are required to:

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

The directors of PDL are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Funds and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company and to prevent and detect fraud and other irregularities.

In accordance with its responsibility for the management of the Funds, the Scottish Amicable Board has reviewed and, having received appropriate assurances from Prudential Distribution Limited and the Monitoring Actuary, has approved the financial statements for the year ended 31 December 2012.

Disclosure of information to auditor

The directors of PDL who held office at the date of approval of this Board report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditor is unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

Financial instruments

The Fund is exposed to financial risk through its financial assets, financial liabilities, and policyholder liabilities. The financial risk factors affecting the Fund include market risk, credit risk and liquidity risk. Information on the financial risk management objectives and policies of the Fund and the exposure of the Fund to the financial risk factors is given in note 17.

Further information on the use of derivatives by the Fund is provided in note 17.

Auditors

A resolution for the re-appointment of KPMG Audit Plc as auditors was proposed at the annual general meeting of PAC.

Directors' and officers' protection

Prudential plc has arranged appropriate insurance cover in respect of legal action against directors and senior managers of companies within the Prudential Group. In addition, the Articles of Association of the Company provide for the directors, officers and employees of the Company to be indemnified in respect of liabilities incurred as a result of their office. Prudential plc also provides protections for directors and senior managers of companies within the Group against personal financial exposure they may incur in their capacity as such. These include qualifying third party indemnity provisions (as defined by the relevant Companies Act) for the benefit of directors of Prudential plc, including, where applicable, in their capacity as a director of the Company and other companies within the Group. These indemnities were in force during 2012 and remain in force.

With-Profits Governance

PAC produces an annual report, which is available on request, setting out how it has complied with its Principles and Practices of Financial Management (PPFM).

The Board of PAC has established a With-profits Committee (WPC), made up of at least three members (each of whom is external and independent of the Company). The WPC provides the Board of PAC with an independent assessment of the way in which the Company manages its with-profits business, its compliance with the PPFM, and how the Company balances the rights and interests of policyholders and shareholders in relation to its with-profits funds. The WPC has the right, if it wishes, to make a statement to with-profits policyholders in addition to the Company's report described above.

PAC has a With-Profits Actuary who has the specific duty to advise the Board of PAC on the application of discretion in relation to with-profits business; and an Actuarial Function Holder who will provide the Board of PAC with all other actuarial advice. Both of these are Financial Services Authority approved roles.

Within this framework, the process by which decisions relating to with-profits issues are made in respect of the Fund is as follows:

(i) the Actuarial Function Holder will make recommendations to the Scottish Amicable Board;

(ii) the Monitoring Actuary will advise the Scottish Amicable Board on the appropriateness of the recommendations in relation to the Scheme;

(iii) the Scottish Amicable Board will take the decision, having regard solely to the interest of the Fund's policyholders;

(iv) the With-Profits Actuary will advise the PAC Board on the appropriateness of the Scottish Amicable Board's decision, having regard to the company's PPFM;

(v) the With-Profits Committee will review the decision for consistency with the PPFM; and

(vi) the PAC Board will ratify the Scottish Amicable Board's decision.

On behalf of the Scottish Amicable Board

Susan Windridge

Secretary

16 May 2013

INDEPENDENT AUDITORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2012

Independent auditors' report to the members of the Scottish Amicable Funds (the Funds)

We have audited the financial statements of the Funds for the year ended 31 December 2012 on pages 11 to 30. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the Funds' members, as a body, in accordance with The Scheme. Our audit work has been undertaken so that we might state to the Funds' members those matters we are required to state to them in an auditors' 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 Funds and the Funds' members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 7, 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 (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Funds' affairs as at 31 December 2012 and the profit for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Scheme.

Robert Lewis

Robert Lewis (Senior Statutory Auditor)
For and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
Canary Wharf
London, E14 5GL

24 May 2013

PROFIT AND LOSS ACCOUNT FOR THE FUND FOR THE YEAR ENDED 31 DECEMBER 2012

		Note	2012 £m	2011 £m
Long-term business technical account				
Gross premiums written		2	140.0	169.2
Outward reinsurance premiums			(38.4)	(31.7)
Earned premiums, net of reinsurance			101.6	137.5
Investment income and realised gains		3	778.1	802.0
Unrealised gains / (losses) on investments		3	36.7	(448.1)
			814.8	353.9
Claims incurred, net of reinsurance				
Claims paid	gross amount		(1,687.7)	(1,797.8)
	reinsurers' share		202.8	178.5
Claims paid, net of reinsurance			(1,484.9)	(1,619.3)
Change in provision for claims	gross amount		0.3	(8.9)
	reinsurers' share		0.2	(0.1)
Claims incurred, net of reinsurance			(1,484.4)	(1,628.3)
Change in long-term business provisions				
	gross amount	12	662.3	1,209.0
	reinsurers' share	12	14.2	1.8
			676.5	1,210.8
Other charges				
Net operating expenses		5	(34.0)	(37.2)
Investment expenses and charges		3	(26.0)	(30.8)
Tax attributable to the long-term business		6	(48.5)	(5.9)
			(108.5)	(73.9)
Transfer to fund for future appropriations		7	-	-

All amounts included in the 2012 and 2011 profit and loss account shown above are in respect of continuing operations.

The Fund has no recognised gains or losses, other than the transfer to fund for future appropriations. Accordingly, a statement of total recognised gains and losses is not given.

The technical account reflects the activities of the Fund.

	2012 £m	2011 £m
Non-technical account		
Balance on the long-term business technical account	-	-
Investment income	45.8	63.7
Investment gains / (losses)	78.9	(19.9)
Investment expenses and charges		
Interest charges	(0.2)	(0.2)
Profit on ordinary activities before tax	124.5	43.6
Tax on profit on ordinary activities		
Current tax charge	(8.9)	(2.8)
Deferred tax credit	15.1	1.4
Profit for the financial year	130.7	42.2

The non-technical account reflects the activities of the Capital Fund.

SCOTTISH AMICABLE FUNDS

BALANCE SHEET FOR THE FUND AS AT 31 DECEMBER 2012

	Note	2012 £m	2011 £m
Investments			
Land and buildings	8	**506.5**	579.4
Investments in group undertakings	8	**264.4**	289.2
Other financial investments	9	**7,240.0**	7,907.6
		8,010.9	8,776.2
Reinsurers' share of technical provisions			
Long-term business provision	12	**482.7**	468.5
Claims outstanding		**-**	0.1
Technical provisions for linked liabilities		**1,624.1**	1,633.7
		2,106.8	2,102.3
Debtors	10	**13.6**	16.1
Other assets			
Cash at bank and in hand		**120.3**	111.8
		120.3	111.8
Prepayments and accrued income			
Accrued interest and rent		**60.6**	73.0
Other prepayments and accrued income		**8.3**	12.7
		68.9	85.7
		10,320.5	11,092.1
Subordinated liabilities	13	**100.0**	100.0
Fund for future appropriations	7	**-**	-
Technical provisions			
Long-term business provision	12	**8,259.9**	8,922.2
Claims outstanding		**99.2**	99.5
		8,359.1	9,021.7
Technical provisions for linked liabilities		**1,624.1**	1,633.7
Provisions for other risks and charges	6	**38.4**	39.8
Creditors			
Creditors arising out of direct insurance operations		**0.4**	0.5
Other creditors including taxation and social security	11	**189.5**	286.6
		189.9	287.1
Accruals and deferred income		**9.0**	9.8
		10,320.5	11,092.1

The accounts on pages 11 to 30 were approved by the Scottish Amicable Board on 16 May 2013.

Bernard Solomons
Chairman

Finbar O'Dwyer
Board Member

SCOTTISH AMICABLE FUNDS

BALANCE SHEET FOR THE CAPITAL FUND AS AT 31 DECEMBER 2012

	2012 £m	2011 £m
Investments		
Land and buildings	139.0	147.9
Shares and other variable yield securities and units in unit trusts	248.6	497.5
Debt securities and other fixed income securities	667.6	723.7
Other financial investments	916.2	1,221.2
	1,055.2	1,369.1
Debtors	-	0.4
Other assets		
Cash at bank and in hand	407.1	169.3
	1,462.3	1,538.8
Capital Fund surplus	1,208.1	1,322.5
Provisions for other risks and charges		
Deferred taxation	0.2	15.4
Creditors		
Amounts due to fellow group undertakings	245.1	198.1
Tax payable	8.9	2.8
Other creditors including taxation and social security	254.0	200.9
	1,462.3	1,538.8

Reconciliation of the movement in the Capital Fund surplus for the year ended 31 December 2012

	2012 £m	2011 £m
Profit for the financial year	130.7	42.2
Reduction by reason of excess	(245.1)	(198.1)
Capital Fund surplus at beginning of year	1,322.5	1,478.4
Capital Fund surplus at end of year	1,208.1	1,322.5

The reduction by excess is in accordance with the Scheme requirement to annually reduce the Capital Fund so its net assets are equal to 15% of the average value of the with-profit assets of the Scottish Amicable Insurance Fund. This reduction by excess is paid into the long term assets of PAC's with-profit investments.

Given the structure of the Funds, the financial disclosures given in the notes only refer to the assets and liabilities of the Fund and not the Capital Fund, unless stated otherwise. This is because it is only the Fund that will pay the policyholders.

NOTES TO THE FINANCIAL STATEMENTS

1. Accounting Policies

A. Change in accounting policies

In 2012, the Fund adopted "Amendments to FRS29 (IFRS 7) - Financial Instruments: Disclosures - Disclosures - Transfers of Financial Assets", which had no material impact on the financial statements of the Fund.

B. Basis of preparation of accounts

The financial statements are prepared in accordance with Part 15 of the Companies Act 2006 and Schedule 3 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 as if they applied to the Funds. The financial statements comply with applicable accounting standards (UKGAAP) and the ABI SORP, and have been prepared under the historical cost accounting rules, modified to include the revaluation of investments.

The accounts reflect the income and expenditure, assets and liabilities of the Scottish Amicable Insurance Fund ("the Fund") and the Scottish Amicable Capital Fund ("Capital Fund"). The Fund operates as a mutual fund whereby all results are wholly attributable to its members and are shown in the long term technical account. The Capital Fund is a hypothecation of assets from The Prudential Assurance Company's with profit fund established under the Scheme to provide capital support to the Fund. The results of its activities are shown in the non-technical profit and loss account.

Scheme rules require the assets of the Fund and the Capital Fund to be strictly segregated and the balance sheets reflect this requirement and show assets and liabilities of the Fund and Capital Fund separately. There were no changes to the results of the net assets as a result of this presentation.

The Funds have taken advantage of the rules which would have permitted a company in the same circumstances not to have prepared consolidated financial statements nor to have presented a cash flow statement or comply with FRS 27.

The directors of PDL have a reasonable expectation that the Funds will be able to continue in operational existence for a period greater than 12 months from the balance sheet date and thus continue to adopt the going concern basis of accounting in preparing the financial statements. This conclusion has been based upon the following: the Funds are part of PAC, a subsidiary within the Prudential Group and it, its parent company which is the ultimate parent company are continuing to trade and there are no plans for liquidation, the Company, of which the Funds are a part, has a healthy solvency margin, well in excess of the Minimum Capital Requirement (MCR) and Enhanced Capital Requirement (ECR), is supported by its inherited estate, generates positive cashflows, and has very low debt-financing. In addition consideration has also been given to the Fund's performance, the market in which it operates, its strategy and risks and uncertainties, the management of financial risk as set out in note 17, including its exposure to liquidity risk and credit risk.

C. Long-term Business

Technical account treatment

Premiums and annuity considerations for conventional with-profit policies and other protection type life insurance policies are accounted for when due. For unit linked business and unitised with-profit policies, premiums are accounted for when the liabilities arising from the premiums are created. Premiums exclude any taxes or duties based on premiums.

Maturity claims are accounted for on the policy maturity date; annuities are accounted for when the annuity becomes due for payment; surrenders are accounted for when paid; and death claims are accounted for when notified.

Bonus additions made to policies are included in the change in the long-term business provision or, where the policy is no longer in force, in claims incurred.

Fund for future appropriations

The fund for future appropriations represents all funds where the allocation to policyholders has not yet been determined.

In determining the amount of liabilities and fund for future appropriations the Fund has applied the approach previously followed of showing the working capital as zero, as the fund will be distributed fully. Without this change of approach the fund for future appropriations for the Fund would have been £218m (2011: £315m) rather than zero.

Long-term business provision

The assumptions used to calculate the long-term business provisions are described in note 12.

FRS 27 is underpinned by the FSA's Peak 2 realistic basis of reporting. Realistic reserves are established using best estimate assumptions, and taking into account the firm's regulatory duty to treat its customers fairly.

The FSA realistic value of liabilities is calculated as:

(i) a with-profits benefits reserve (WPBR) plus
(ii) future policy related liabilities (FPRL) plus
(iii) the realistic current liabilities of the Fund

The WPBR is the main component of the product related liability, and is mainly determined using a retrospective asset share calculation.

Asset shares are calculated by rolling up the premiums paid, less expenses and charges using the actual investment returns earned on the with-profits fund. The assumptions used within the asset share calculations are consistent with those that are actually used to determine policyholders' bonuses. A number of adjustments are made to reflect future expected policyholder benefits and other outgoings. For certain conventional with-profits policies a prospective bonus reserve valuation is performed instead, valuing future claims and expenses using the expected future bonus rates.

The liabilities include a market consistent valuation of the costs of guarantees, options and smoothing. This is determined using stochastic modelling. The liabilities include £388m (2011: £370m) in respect of annuity rate guarantees at vesting or on maturity attaching to certain pension products.

The FPRL also includes the distribution of surplus from non-profit business. For the Fund, the FSA realistic liability calculation requires that the entire surplus within the fund is distributed to policyholders and therefore the FPRL is increased up to the point where the Fund has no working capital.

The reported assets include the present value of future profits of non-profit business written within the with-profit funds. These assets are adjusted from the values reported in the FSA realistic balance to reflect differences in the provisioning and capital requirements between the accounting and FSA realistic basis.

D. Reinsurance

In the normal course of business the Fund seeks to reduce loss exposure by reinsuring certain levels of risk in various areas of exposure with other insurance companies or reinsurers. An asset or liability is recognised in the balance sheet representing premiums due to or payments due from reinsurers and the share of benefits and claims recoverable from reinsurers. The measurement of reinsurance assets is consistent with the measurement of the underlying direct insurance contracts.

E. Investments

Investment income and realised and unrealised gains in respect of long-term business are included in the long-term business technical account.

Realised gains are determined as the difference between net proceeds on disposal and the purchase price. Movements in unrealised gains comprise the change in the value of investments held at the balance sheet date and the reversal of unrealised investment gains and losses recognised in earlier accounting periods in respect of investment disposals.

Under FRS 26, upon initial recognition financial investments are recognised at fair value. Subsequently, the Fund is permitted, subject to specific criteria, to designate its investments as either financial investments at fair value through profit and loss, financial investments held on an available-for-sale basis, financial investments held to maturity, or loans and receivables. The Fund holds financial investments on the following bases:

(i) Financial investments at fair value through profit and loss – this comprises assets designated by management as fair value through profit and loss on inception and derivatives deemed to be held for trading. These investments are valued at fair value with all changes thereon being recognised in the profit and loss account. An analysis of net gains/losses is disclosed separately in Note 3.

The Fund uses bid prices to value its quoted financial investments. Actively traded investments without quoted prices are valued using external broker bid prices. If there is no active established market for an investment, the Fund applies an appropriate valuation technique such as discounted cash flow technique. Further information on valuation techniques is provided in Note 17.

(ii) Loans and receivables – these comprise investments that have fixed or determinable payments and are not designated as fair value through profit and loss or available-for-sale. These investments are carried at amortised cost using the effective interest method and subject to impairment reviews. The Fund measures the amount of the impairment loss by comparing the amortised cost with the present value of its estimated future cash flows discounted at the original effective interest rate.

Where investments in group undertakings are held by the Fund, they are reflected at current underlying net asset value in the balance sheet.

Properties are valued annually by professional external valuers at market value as defined in the Appraisal and Valuation Manual issued by the Royal Institute of Chartered Surveyors in particular Practice statement 3.2. In accordance with SSAP 19, no depreciation is provided on investment properties as the directors consider that to depreciate them would not give a true and fair view.

F. Taxation

Tax is charged on all taxable profits arising in the accounting period. The UK HM Revenue & Customs rules for taxing long-term business are significantly different to those applying to non-insurance companies and the different classes of business written by the Fund are themselves subject to distinct rules.

The UK Government has made substantial changes to the rules relating to the taxation of life insurance companies, effective from 1 January 2013. Until the end of 2012, shareholders' taxable profits are calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for UK GAAP. Beginning in 2013, under new life tax rules, taxable profits will be calculated using accounting profit or loss as a starting point.

Except where otherwise required by accounting standards, full provision for deferred tax without discounting is made for all timing differences which have arisen but not reversed at the balance sheet date.

G. Foreign currencies

Foreign currency revenue transactions are translated at average exchange rates for the year. Monetary foreign currency assets and liabilities are translated at year end exchange rates. Exchange differences are included in the profit and loss account.

2. Gross premium analysis

	2012 £m	2011 £m
Gross premiums written:		
Direct	**107.2**	131.3
Reinsurance accepted	**32.8**	37.9
	140.0	169.2

Reinsurance accepted comprises amounts reassured into the Fund by Scottish Amicable Account in respect of with-profits contracts.

	2012 £m	2011 £m
By individual and group		
Individual business	**106.6**	130.3
Group contracts	**0.6**	1.0
	107.2	131.3
By frequency		
Regular premiums	**85.9**	108.5
Single premiums	**21.3**	22.8
	107.2	131.3

DWP rebates and annuity business from policy surrenders are classified as new single premiums. All premiums arise from business conducted in the UK, and relate mainly to participating business.

3. Investment income and expenses

(a) Investment income and realised gains and (losses)	2012 £m	2011 £m
Income from:		
Land and buildings	**40.8**	42.1
Listed investments	**262.0**	315.6
Unlisted investments	**17.8**	47.9
Other investments	**27.8**	31.1
Interest receivable from group undertakings	**6.1**	6.5
Other income	**0.5**	0.3
Total income	**355.0**	443.5
Realised gains and (losses) from:		
Land and buildings	**(8.7)**	2.8
Loans and receivables	**(3.8)**	6.9
Realisation of investments at fair value through profit and loss other than derivatives	**406.3**	349.2
Exchange (losses)	**(11.9)**	(3.8)
Realisation of derivatives	**41.2**	3.4
Total realised gains	**423.1**	358.5
Total investment income and realised gains and losses	**778.1**	802.0

(b) Unrealised gains and (losses) on investments	2012 £m	2011 £m
Land and buildings	**(33.9)**	(15.3)
Equity	**(31.5)**	(425.7)
Bonds	**44.2**	37.2
Other	**57.9**	(44.3)
	36.7	(448.1)

(c) Investment expenses and charges	2012 £m	2011 £m
Investment management fees payable to group undertakings	**14.3**	13.5
Property investment expenses	**3.2**	8.8
Interest payable to group undertakings	**8.5**	8.5
	26.0	30.8

4. Bonuses

Bonuses added during the year are included in the long-term business provision or, where the policy is no longer in force, in claims incurred. The total cost of bonuses in 2012 was £541.1m (2011: £611.2m).

5. Net operating expenses

	2012 £m	2011 £m
Capital fund support charge	**11.9**	13.2
Commission	**2.2**	2.7
Administration charges	**19.9**	21.3
	34.0	37.2

The remuneration of the auditors in respect of the statutory audit was £80,000 (2011: £80,000). This is paid by PAC. The remuneration of the monitoring actuary for the year was £59,952 (2011: £61,238). The emoluments for the highest paid board member were £37,904 (2011: £39,407). Total fees payable in the year to 31 December 2012 were £163,497 (2011: £153,000).

6. Taxation

(a) Tax charged	**2012 £m**	2011 £m
Current tax:		
UK corporation tax on profit for the year	**49.9**	40.9
Adjustment in respect of previous years	**(3.3)**	0.7
Overseas tax	**3.3**	3.2
	49.9	44.8
Deferred tax:		
Origination and reversal of timing differences	**(1.4)**	(38.9)
Total charge for the year	**48.5**	5.9

(b) Provision for deferred tax	**2012 £m**	2011 £m
Deferred tax:		
Acceleration of capital allowances	**(0.1)**	(0.2)
Unrealised investment gains	**39.5**	41.1
Deferred acquisition costs	**(1.0)**	(1.1)
Total provisions	**38.4**	39.8

Movements on deferred tax liabilities are as follows:

Deferred tax liability at 1 January	**39.8**	78.7
Deferred tax (credited) in the year	**(1.4)**	(38.9)
Deferred tax liability at 31 December	**38.4**	39.8

The UK Government has made substantial changes to the rules relating to the taxation of life insurance companies, effective from 1 January 2013. Until the end of 2012 tax is calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for UK GAAP. Beginning in 2013, under new life tax rules, taxable profits will be calculated using accounting profit or loss as a starting point.

At the end of 2012, a deferred tax liability is recognised for the transitional adjustment that arises from the difference in retained UK GAAP profits and taxed surplus which is required to be spread and taxed over a 10 year period.

The effect of these changes is reflected in the financial statements for the year ended 31 December 2012 but has had no material impact on the company's net assets.

7. Fund for future appropriations

The fund for future appropriations is £nil (2011: £nil) as the Fund will be pursuant to the Scheme fully distributed to its members.

8. Investments

(a) Land and buildings	**2012 £m**	2011 £m
Current value:		
Freehold	**383.2**	451.4
Leasehold with a term of over 50 years	**123.3**	128.0
	506.5	579.4
Cost:	**438.3**	477.3

(b) Investments in group undertakings	**2012 £m**	2011 £m
Current value:		
Shareholdings	**167.9**	172.2
Loans	**96.5**	117.0
	264.4	289.2
Cost:		
Loans	**96.5**	117.0

9. Other financial investments

	Cost		Carrying value	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Shares and other variable yield securities and units in unit trusts	**1,668.0**	2,003.9	**2,068.1**	2,441.7
Debt securities and other fixed income securities	**3,511.6**	4,041.5	**3,863.5**	4,349.2
Mortgage loans	**22.4**	30.3	**22.4**	30.3
Loans to policyholders secured by insurance policies	**6.8**	8.8	**6.8**	8.8
Other loans	**104.7**	119.6	**86.7**	104.0
Participation in investment pools	**161.8**	170.0	**214.3**	218.8
Deposits with credit institutions	**909.6**	693.3	**909.6**	693.3
Derivative asset	**-**	-	**68.6**	61.5
	6,384.9	7,067.4	**7,240.0**	7,907.6

The table below analyses the derivative positions of the Fund.

	2012 £m		2011 £m	
	Fair value assets	**Fair value liabilities**	Fair value assets	Fair value liabilities
Derivative financial instruments held to manage credit, interest rate and currency profile:				
Interest rate swaps	**21.1**	**24.2**	18.7	25.3
Cross currency swaps	**15.1**	**0.1**	-	-
Currency exchange forward contracts	**32.0**	**7.4**	26.0	19.1
Bond futures	**0.1**	**3.9**	1.5	26.2
Credit default swaps	**0.2**	**-**	3.9	0.6
Derivative financial instruments held to manage equity risk and for efficient investment management:				
Equity options	**-**	**-**	11.0	-
Equity index futures contracts	**0.1**	**0.1**	0.4	1.0
Total at 31 December	**68.6**	**35.7**	61.5	72.2

10. Debtors

	2012 £m	2011 £m
Amounts due from fellow group undertakings	**0.8**	0.3
Tax recoverable	**1.0**	5.4
Other	**11.8**	10.4
	13.6	16.1

11. Other creditors including tax and social security

	2012 £m	2011 £m
Amounts due to fellow group undertakings	**10.8**	9.3
Tax payable	**25.6**	23.1
Derivative liability (see note 9)	**35.7**	72.2
Stock lending creditor	**107.6**	178.4
Other	**9.8**	3.6
	189.5	286.6

12. Long-term business provision

With-profits business

<u>Assumptions for Realistic Reserves</u>

The overarching principle in assumption setting is that realistic provisions are established using best estimate assumptions, taking into account the firm's regulatory duty to treat its customers fairly.

Assumptions are required in three areas, namely:

(i) Retrospective assumptions.
(ii) Prospective assumptions, and
(iii) Stochastic modelling assumptions - economic asset model and management actions

Retrospective assumptions

Retrospective assumptions are required for the accumulation of past asset shares up to the valuation date. These assumptions are determined by reference to actual past experience in relation to investment returns, expenses and miscellaneous surplus. The assumptions include past expense write-offs and enhancements to asset shares, and are as used when calculating specimen asset shares for the purpose of bonus setting.

The 2012 year end Investment Return for asset shares is:

Gross return	9.73%
Net return	8.16%

Prospective assumptions

Prospective assumptions are required for the adjustments to asset shares for the valuation of non-profit business, and for the stochastic modelling of the cost of guarantees, options and smoothing.

For asset share adjustments, the economic assumptions used represent our best estimate assumptions allowing for prevailing market conditions at the valuation date.

For stochastic modelling, the economic assumptions used are calibrated to risk-free returns and market prices to produce market consistent valuations of guarantees and options.

The value of non-profit business written is taken as the embedded value of the business calculated using risk free returns and discount rates.

Expense assumptions have been taken as the level of expenses incurred during 2012.

The mortality assumption has been set to the best estimate assumptions underlying the European Embedded Value.
The table below shows the 2012 mortality bases:

Product	Mortality Table (M/F)	Age Rating Years (M/F)	Multiplier % (M/F)
Life Term Business	AM92 / AF92	+1 / +1	70
Other SP Life Business	AM92 / AF92	+1 / +1	70
Other RP Life Business	AM92 / AF92	+1 / +1	70
Pension Term Business	AM92 / AF92	+1 / +1	70
Other Pension Business	AM92 / AF92	+1 / +1	70
AWP Life (Home Purchaser)	AM92 / AF92	+1 / +1	70

For persistency, the assumptions are best estimate based on recent experience analyses. The persistency assumptions used to value the cost of options and guarantees are reduced by a 10% margin to make approximate allowance for the impact of policyholders' group actions in extreme market scenarios.

Stochastic asset model economic calibration and management actions

The cost of options, guarantees and smoothing are assessed on a market consistent basis, so that the reserves held are equal to the theoretical cost of hedging the guarantees in the market. In the absence of a deep, liquid market these costs are assessed using a "market consistent" model, with a market consistent calibration.

In order to value the Fund's guarantees and options, the stochastic asset/liability model projects the with-profits liabilities forward over the next 40 years for 5,000 separate economic scenarios. The risk free rate was assumed to be the gilt rate.

Separate asset models are used for the risk free rate, UK equities, overseas equities, corporate bonds, property and real interest rates. Where appropriate securities or derivatives are traded, we have demonstrated that the model is able to closely reproduce these prices. Where this is not the case (for example for property and corporate bonds) we have applied expert judgement. We have also allowed for the correlation of investment returns between different asset classes.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction and investment policy that the company will employ under varying investment conditions. Our stochastic modelling incorporates several management actions to protect the Fund in adverse investment scenarios. These management actions are consistent with the PPFM and our obligation to treat customers fairly.

Investment-linked business

A non-unit reserve is held for mortality, morbidity and expenses (including investment management expenses and other outgoings associated with payments to third parties). There has been no change in policy from 2011.

Other non-linked business

Provisions are calculated by the net premium valuation method on the following bases:

	2012		2011	
	Interest rate %	Actuarial mortality table reference	Interest rate %	Actuarial mortality table reference
Non profit retirement annuities*	2.75		3.50	
– In deferment		AM/AF92-4		AM/AF92-4
– In payment		92% PCMA00, 84% PCFA00 with improvements in line with a custom calibration of the CMI's 2011 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.50% for females		95% PCMA00, 86% PCFA00 with improvements in line with a custom calibration of the CMI's 2009 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.25% for females
Non profit immediate annuities (Individual)	3.76	94% PCMA00, 86% PCFA00 with improvements in line with a custom calibration of the CMI's 2011 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.50% for females	4.39	95% PCMA00, 86% PCFA00 with improvements in line with a custom calibration of the CMI's 2009 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.25% for females
Non profit immediate annuities (Group)	3.76	94% PCMA00, 86% PCFA00 with improvements in line with a custom calibration of the CMI's 2011 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.50% for females	4.39	94% PCMA00, 85% PCFA00 with improvements in line with a custom calibration of the CMI's 2009 mortality model, with a long-term mortality improvement rate of 2.25 % for males and 1.25% for females
Non profit life assurances	2.25	AM/AF92+1 plus 1/3 AIDS 'R6A'	2.75	AM/AF92+1 plus 1/3 AIDS 'R6A'
Non profit pension assurances	2.75	AM/AF92+1 plus 1/3 AIDS 'R6A'	3.50	AM/AF92+1 plus 1/3 AIDS 'R6A'

* For retirement annuities, the interest rate used is adjusted where appropriate to allow for mortality improvements during deferment. The improvement to the mortality rates noted above in 2011 leads to a slight increase in the life expectancy. Life expectancy at age 65 (for someone currently aged 45) has increased from 28.6 years to 29.2 years for men and from 27.9 years to 30.0 years for women.

Other long term business provision

At 31 December 2012 a provision of £12m (2011: £15m) is held to meet compensation payments arising from 'business as usual' complaints from endowment policyholders. The provision has been calculated as a best estimate of the future compensation costs to policyholders who have not been time-barred from having their endowment policy reviewed. In addition, a provision of £388m (2011: £370m) is held to cover the Fund's exposure due to guaranteed annuities.

13. Subordinated liabilities

In 1994, Scottish Amicable Finance plc (a wholly owned subsidiary of PAC) issued £100m of 8.5% undated subordinated guaranteed bonds. The interests of the holders of the bonds issued by Scottish Amicable Finance plc are subordinated to the entitlements of the policyholders of the Fund. The bonds are guaranteed by the Fund. The proceeds of the issue were lent to the Fund on equal terms as to interest, repayment and subordination as those applicable to the bonds.

14. Contingent liabilities

A contingent liability exists in respect of future levies, which may arise under the Financial Services Compensation Scheme. It is not practicable to estimate the financial effect of this contingent liability.

15. Related party transactions

Both the Scottish Amicable Insurance fund and the Scottish Amicable Capital fund are funds within PAC, itself a subsidiary of Prudential plc and has taken advantage of the exemption under paragraph 3(c) of Financial Reporting Standard 8 relating to the disclosure of transactions with other wholly owned subsidiary undertakings of the Prudential group.

16. Ultimate parent company

The ultimate parent company of PAC is Prudential plc, which is the only parent company to prepare group accounts, copies of which can be obtained from the Company Secretary, Laurence Pountney Hill, London, EC4R OHH.

17. Financial assets and liabilities

A. Financial instruments – designation and fair values

All financial assets of the Fund are designated as either fair value through profit and loss or loans and receivables. Financial liabilities are designated as either fair value through profit and loss, amortised cost or investment contracts with discretionary participation features accounted for under FRS 26 and the ABI SORP as described in the Accounting Policies section.

2012 £m	**Fair value through profit and loss**	**Loans and receivables**	**Total carrying value**	**Fair value**
Financial Assets				
Deposits with credit institutions	**-**	**909.6**	**909.6**	**909.6**
Equity securities and portfolio holdings in unit trusts	**2,068.1**	**-**	**2,068.1**	**2,068.1**
Debt securities and other fixed income securities (note iii)	**3,863.5**	**-**	**3,863.5**	**3,863.5**
Loans (note ii)	**-**	**115.9**	**115.9**	**111.6**
Other investments (note v)	**214.3**	**-**	**214.3**	**214.3**
Derivative asset	**68.6**	**-**	**68.6**	**68.6**
Accrued investment income	**-**	**68.9**	**68.9**	**68.9**
Other debtors	**-**	**12.6**	**12.6**	**12.6**
Cash at bank and in hand	**-**	**120.3**	**120.3**	**120.3**
Total	**6,214.5**	**1,227.3**	**7,441.8**	**7,437.5**

	Fair value through profit and loss	**Amortised cost**	**ABI SORP/ FRS26**	**Total carrying value**	**Fair value**
Financial Liabilities					
Subordinated liabilities	**-**	**100.0**	**-**	**100.0**	**100.0**
Investment contracts with discretionary participation features (note i)	**-**	**-**	**412.8**	**412.8**	**-**
Creditors arising out of direct insurance operations	**-**	**0.4**	**-**	**0.4**	**0.4**
Other creditors	**-**	**128.2**	**-**	**128.2**	**128.2**
Derivative liabilities	**35.7**	**-**	**-**	**35.7**	**35.7**
Total (note i)	**35.7**	**228.6**	**412.8**	**677.1**	**264.3**

2011 £m	Fair value through profit and loss	Loans and receivables	Total carrying value	Fair value
Financial Assets				
Deposits with credit institutions	-	693.3	693.3	693.3
Equity securities and portfolio holdings in unit trusts	2,441.7	-	2,441.7	2,441.7
Debt securities and other fixed income securities (note iii)	4,349.2	-	4,349.2	4,349.2
Loans (note ii)	-	143.1	143.1	130.5
Other investments (note v)	218.8	-	218.8	218.8
Derivative asset	61.5	-	61.5	61.5
Accrued investment income	-	85.7	85.7	85.7
Other debtors	-	10.7	10.7	10.7
Cash at bank and in hand	-	111.8	111.8	111.8
Total	7,071.2	1,044.6	8,115.8	8,103.2

	Fair value through profit and loss	Amortised cost	ABI SORP/ FRS26	Total carrying value	Fair value
Financial Liabilities					
Subordinated liabilities	-	100.0	-	100.0	100.0
Investment contracts with discretionary participation features (note i)	-	-	374.0	374.0	-
Creditors arising out of direct insurance operations	-	0.5	-	0.5	0.5
Other creditors	-	191.3	-	191.3	191.3
Derivative liabilities	72.2	-	-	72.2	72.2
Total (note i)	72.2	291.8	374.0	738.0	364.0

Notes

(i) As at 31 December 2012 and 31 December 2011 it is impractical to determine fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features. The amounts of investment contracts with discretionary participation features are included within the Long-term business provision.

(ii) Loans and receivables are reported net of allowance for loan losses of £18.0m (2011: £15.6m).

(iii) As at 31 December 2012, £3.2m (2011: £3.9m) of convertible bonds were included in debt securities. There were no convertible bonds included in borrowings.

(iv) For financial liabilities designated as fair value through profit and loss there was no material impact on profit from movements in credit risk during 2012 and 2011.

(v) Other investments include participation in various investment funds and limited liability property partnerships.

Determination of fair value

The fair values of the financial assets and liabilities as shown in the table above have been determined on the following bases.

The fair values of the financial instruments for which fair valuation is required under UK GAAP are determined by the use of current market bid prices for quoted investments, or by using quotations from independent third-parties, such as brokers and pricing services or by using appropriate valuation techniques. Investments valued using valuation techniques include financial investments which by their nature do not have an externally quoted price based on regular trades and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. The valuation techniques used include comparison to recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation. These techniques may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments. When determining the inputs into the valuation techniques used priority is given to publicly available prices from independent sources, when available but overall, the source of pricing is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses from selling the financial instrument being fair valued. In some cases the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realised in immediate settlement of the financial instrument.

The loans and receivables have been shown net of provisions for impairment. The fair value of loans has been estimated from discounted cash flows expected to be received. The rate of discount used was the market rate of interest.

The estimated fair value of derivative financial instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. This amount is determined using quoted prices if exchange listed, quotations from independent third-parties or valued internally using standard market practices.

Level 1, 2 and 3 fair value measurement hierarchy of financial instruments

The table below includes financial instruments carried at fair value analysed by level of the FRS29 defined fair value hierarchy. This hierarchy is based on the inputs to the fair value measurement and reflects the lowest level input that is significant to that measurement.

The classification criteria and its application to the Fund can be summarised as follows:

Level 1 – quoted prices (unadjusted) in active markets for identical assets and liabilities

Level 1 principally includes exchange listed equities, mutual funds with quoted prices, exchange traded derivatives such as futures and options, and national government bonds unless there is evidence that trading in a given instrument is so infrequent that the market could not possibly be considered active. It also includes other financial instruments where there is clear evidence that the year end valuation is based on a traded price in an active market.

Level 2 – inputs other than quoted prices included within level 1 that are observable either directly (i.e. as prices) or indirectly (i.e. derived from prices)

Level 2 principally includes corporate bonds and other non-national government debt securities which are valued using observable inputs, together with over-the-counter derivatives such as forward exchange contracts and non-quoted investment fund valued with observable inputs. It also includes investment contract liabilities that are valued using observable inputs.

In addition level 2 includes debt securities that are valued internally using standard market practices. Of the total level 2 debt securities of £3,368.2m (2011: £3,723.8m), £187.1m (2011: £208.4m) are valued internally. The majority of such securities use matrix pricing, which is based on assessing the credit quality of the underlying borrower to derive a suitable discount rate relative to government securities. Under matrix pricing, the debt securities are priced taking the credit spreads on comparable quoted public debt securities and applying these to the equivalent debt instruments factoring a specified liquidity premium. The significance of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

Level 3: Significant inputs for the asset or liability that are not based on observable market data (unobservable inputs)

Level 3 principally includes investments in private equity funds, investments in property funds which are exposed to bespoke properties or risks, investments which are internally valued or subject to a significant number of unobservable assumptions. It also includes debt securities which are rarely traded or traded only in privately negotiated transactions and hence where it is difficult to assert that these have been based on observable market data. The inherent nature of the vast majority of these assets means that, in normal market conditions, there is unlikely to be significant change in the specific underlying assets classified as level 3.

At 31 December 2012 the Fund held £222.6m, 4% of the fair valued financial instruments, within level 3 (2011: £264.8m or 4%)

2012 £m	**Level 1**	**Level 2**	**Level 3**	**Total**
Equity securities	**1,996.1**	**71.9**	**0.1**	**2,068.1**
Debt securities	**487.1**	**3,368.2**	**8.2**	**3,863.5**
Other investments (including derivative assets)	**0.2**	**68.4**	**214.3**	**282.9**
Derivative liabilities	**(4.0)**	**(31.7)**	**-**	**(35.7)**
Total financial investments, net of derivative liabilities	**2,479.4**	**3,476.8**	**222.6**	**6,178.8**
Total	**2,479.4**	**3,476.8**	**222.6**	**6,178.8**
Percentage of total	**40%**	**56%**	**4%**	**100%**

2011 £m	Level 1	Level 2	Level 3	Total
Equity securities	2,296.9	105.0	39.8	2,441.7
Debt securities	611.6	3,723.8	13.8	4,349.2
Other investments (including derivative assets)	1.8	67.3	211.2	280.3
Derivative liabilities	(27.2)	(45.0)	-	(72.2)
Total financial investments, net of derivative liabilities	2,883.1	3,851.1	264.8	6,999.0
Total	2,883.1	3,851.1	264.8	6,999.0.
Percentage of total	41%	55%	4%	100%

The above tables relates to the total Fund. The fair value of the assets and liabilities in the Fund all relate to with-profit business.

Reconciliation of movements in level 3 financial instruments measured at fair value

The following table reconciles the value of level 3 financial instruments at 1 January 2012 to that presented at 31 December 2012. Total gains and losses recorded in the long-term technical account in the period represents realised gains and losses, including interest and dividend income, unrealised gains and losses on financial instruments classified at fair value through profit and loss and foreign exchange movements on overseas investments. All these amounts are included within "investment income" and "unrealised gains (losses)" in the long-term technical account.

2012 £m	**At 1 Jan 2012**	**Total gains or (losses) in long-term technical account**	**Purchases**	**Sales**	**Transfers into level 3**	**Transfers out of level 3**	**At 31 Dec 2012**
With-profits							
Equity securities	**39.8**	**7.2**	**-**	**(46.9)**	**-**	**-**	**0.1**
Debt securities	**13.8**	**5.9**	**-**	**(8.5)**	**0.1**	**(3.1)**	**8.2**
Other investments (including derivative assets)	**211.2**	**10.4**	**15.5**	**(22.8)**	**-**	**-**	**214.3**
Total financial investments net of derivative liabilities	**264.8**	**23.5**	**15.5**	**(78.2)**	**0.1**	**(3.1)**	**222.6**
Total	**264.8**	**23.5**	**15.5**	**(78.2)**	**0.1**	**(3.1)**	**222.6**

2011 £m	At 1 Jan 2011	Total gains or (losses) in long-term technical account	Purchases	Sales	Transfers into level 3	Transfers out of level 3	At 31 Dec 2011
With-profits							
Equity securities	50.2	(7.6)	6.8	(2.9)	-	(6.7)	39.8
Debt securities	41.9	7.8	0.4	(33.1)	-	(3.2)	13.8
Other investments (including derivative assets)	215.8	12.9	18.8	(36.3)	-	-	211.2
Total financial investments net of derivative liabilities	307.9	13.1	26.0	(72.3)	-	(9.9)	264.8
Total	307.9	13.1	26.0	(72.3)	-	(9.9)	264.8

Transfers between level 1 and level 2

There were no significant transfers between level 1 and level 2 during the year.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss was £8.4m for the year ended 31 December 2012 (2011: £6.3m). The interest expense on financial liabilities not at fair value through profit and loss was £8.5m for the year ended 31 December 2012 (2011: £8.5m).

B. Market Risk

The financial assets and liabilities attaching to the Fund's life assurance business are, to varying degrees, subject to market risk that may have a material effect on the profit or loss and equity.

Market risk is the risk that the fair value or future cash flows of a financial instrument or, in the case of liabilities of insurance contracts, their carrying value will fluctuate because of changes in market prices.

Market risk comprises four types of risk, namely:

- Interest rate risk: due to changes in market interest rates,
- Liquidity risk: inability to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates
- Currency risk: due to changes in foreign exchange rates, and
- Other price risk: due to fluctuations in market prices (other than those arising from interest rate risk or currency risk).

Interest rate risk

The following table shows an analysis of the classes of financial assets and liabilities with direct exposure to interest rate risk. Each applicable class of the Fund's assets or liabilities are analysed between those exposed to fair value interest rate risk, cash flow interest rate risk and those with no direct interest rate risk exposure.

2012 £m	**Fair value interest rate risk**	**Cash flow interest rate risk**	**Not directly exposed to interest rate risk**	**Total**
Financial Assets				
Deposits with credit institutions	-	909.6	-	909.6
Debt securities	3,572.1	291.4	-	3,863.5
Loans and receivables	30.8	85.1	-	115.9
Derivative asset	36.3	-	32.3	68.6
Cash at bank and in hand	-	120.3	-	120.3
	3,639.2	1,406.4	32.3	5,077.9
Financial Liabilities				
Subordinated liabilities	100.0	-	-	100.0
Derivative liabilities	28.2	-	7.5	35.7
	128.2	-	7.5	135.7

2011 £m	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
Financial Assets				
Deposits with credit institutions	-	693.3	-	693.3
Debt securities	4,074.0	275.2	-	4,349.2
Loans and receivables	45.6	97.5	-	143.1
Derivative asset	27.5	-	34.0	61.5
Cash at bank and in hand	-	111.8	-	111.8
	4,147.1	1,177.8	34.0	5,358.9
Financial Liabilities				
Subordinated liabilities	100.0	-	-	100.0
Derivative liabilities	57.5	-	14.7	72.2
	157.5	-	14.7	172.2

Liquidity analysis

(i) Contractual maturities of financial liabilities

There is no stated maturity date for the Subordinated liability of £100.0m as at the end of 2012 and 2011.

(ii) Maturity analysis of derivatives

The net derivative positions as shown in the table above comprise the following derivative assets and liabilities:

	2012 £m	2011 £m
Derivative assets	**68.6**	61.5
Derivative liabilities	**(35.7)**	(72.2)
Net derivative position	**32.9**	(10.7)

The maturity date of the derivatives is less than one year as at the end of 2012 and 2011. This is due to the basis on which they are managed (i.e. to manage principally asset or liability value exposures). Contractual maturities are not considered essential for an understanding of the timing of the cash flows for these instruments and in particular the Fund has no cash flow hedges.

Currency Risk

As at 31 December 2012, the Fund held 38% (2011:40%) and 21% (2011: 41%) of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency. The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts.

C. Derivatives

The Fund uses derivatives for efficient portfolio management to obtain cost effective and efficient exposure to various markets and to manage exposure to interest rate, currency, credit and other business risks.

The Fund uses various interest rate derivative instruments such as interest rate swaps to reduce exposure to interest rate volatility.

The Fund also uses various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than sterling.

The Fund also holds interest-rate sensitive investments that contain credit risks on which a certain level of defaults is expected. In order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets the Fund purchases swaptions.

All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual group entities, of which PAC, (which the Fund is a sub-fund of), is one, and relevant counterparties in place under each of these market master agreements.

The total fair value balances of derivative assets and derivative liabilities are shown in Note 9.

D. Credit risk

Debt Securities and Other Fixed Income Securities

The following table summarises by the rating the securities held by the Fund as at 31 December 2012 and 2011:

	2012 £m	2011 £m
S&P – AAA	**441.2**	577.8
S&P – AA+ to AA-	**527.2**	552.7
S&P – A+ to A-	**1,031.4**	1,104.4
S&P – BBB+ to BBB-	**911.0**	1,014.1
S&P –Other	**223.3**	310.6
	3,134.1	3,559.6
Moody's – Aaa	**240.3**	263.3
Moody's –Aa1 to Aa3	**41.4**	26.5
Moody's –A1 to A3	**31.9**	41.4
Moody's – Baa1 to Baa3	**54.1**	55.6
Moody's – Other	**14.4**	16.4
	382.1	403.2
Fitch	**19.9**	20.2
Other	**327.4**	366.2
Total debt securities and other fixed income securities	**3,863.5**	4,349.2

In the table above S&P ratings have been used where available. For securities where S&P ratings are not immediately available those produced by Moody's and then Fitch have been used as an alternative. Where no external ratings are available internal ratings produced by the Prudential Group's asset management operations, which are prepared on a comparable basis to external ratings, are used where possible. Of the total debt securities held at 31 December 2012 which are not externally rated, £131.9m (2011: £131.7m) were internally rated AAA to A-, £169.1m (2011: £204.8m) were internally rated BBB+ to B- and £26.4m were internally rated as below B- or unrated (2011: £29.7m).

Loans and receivables

Of the total loans and receivables £1.8m (2011: £0.5m) are past their due date but have not been impaired. In accordance with the accounting policies, impairment reviews were performed for loans and receivables. During the year ended 31 December 2012, impairment losses of £2.3m (2011: £13.0m) were recognised for loans and receivables.

Securities lending and reverse repurchase agreements

The Fund has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third parties, primarily major brokerage firms. The amounts above the fair value of the loaned securities required to be held as collateral by the agreements, depend on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Fund's balance sheet, rather they are retained within the appropriate investment classification. Collateral, typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2012, the Fund had lent £247m (2011: £567m) of securities and held collateral under such agreements of £258m (2011: £595m)

Collateral and pledges under derivative transactions

The amount pledged for assets in respect of Over-the-Counter derivative transactions and repurchase arrangements was £35.6m (2011: £40.6m).

E. Risk Management

The Fund's business involves the acceptance and management of risk. The Fund has in place a risk management process, which is undertaken in accordance with the Group Risk Framework adopted by the Prudential Group in 1999.

A number of risk factors affect the Fund's operating results and financial condition. The financial risk factors affecting the Fund include the effects of market risk, credit risk and liquidity risk on the financial instruments of the Fund.

The Fund uses derivatives to facilitate efficient portfolio management or to reduce investment risk. The most widely used derivatives by the Fund are exchange traded futures and currency forwards. The Fund also uses over-the-counter swaps including total return swaps), options, swaptions and warrants.

It is the Fund's policy that cash or corresponding assets cover amounts at risk through derivative transactions. Derivative financial instruments used to facilitate efficient portfolio management and for investment purposes are carried at fair value with changes in fair value included in the profit and loss account. The Fund has not applied hedge accounting to its derivatives.

Market risk

Market risk is the risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates.

The primary market risks that the Fund faces are equity risk and interest rate risk because most of its assets are investments that are either equity type of investments and subject to equity price risk, or bonds, mortgages or cash deposits, the values of which are subject to interest rate risk.

The split of the Fund's investments between equity investments and interest-sensitive instruments depends principally on the type of liabilities supported by those investments and the amount of capital the Fund has available. This mix of liabilities allows the Fund to invest a substantial portion of its investment funds in equity and real estate investments that the Company believes produce greater returns over the long term. On the other hand the Fund has some liabilities that contain guaranteed returns which generally will be supported by fixed income investments.

Credit risk

Credit risk is the risk that a counterparty or an issuer of securities, which the Fund holds in its asset portfolio, defaults or another party fails to perform according to the terms of the contract. The Fund's long-term fund holds large amounts of interest rate sensitive investments that contain credit risk on which a certain level of defaults are expected. These expected losses are considered when the Fund determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. Certain over-the-counter derivatives contain a credit risk element that is controlled through evaluation of collateral agreements and master netting agreements on interest rate and currency swaps. The Fund is also exposed to credit-related losses in the event of non-performance by counterparties.

Liquidity risk

Liquidity risk is the risk that the Fund may be unable to meet payment obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates. Liquidity management in the Fund seeks to ensure that, even under adverse conditions, the Fund has access to the funds necessary to cover surrenders, withdrawals and maturing liabilities.

In practice, most of the Fund's assets are marketable securities. This combined with the fact that a large proportion of the liabilities contains discretionary surrender values or surrender charges, reduces the liquidity risk.

18. Capital Requirements and Management

Regulatory capital requirements apply at both an individual company level and at the Prudential Group level, of which the Fund is a part, for life assurance and investment management business. The Prudential Group, is currently subject to the solvency requirements of the Insurance Groups Directive (IGD) as implemented by the FSA. Under the IGD a continuous parent company solvency test is applied: Under this test the surplus capital held in each of the regulated subsidiaries, including the Fund, is aggregated with the free assets of non-regulated subsidiaries. From this total, Prudential Group borrowings are deducted, other than subordinated debt issues which qualify as capital.

In addition to obligations under subsidiary and Prudential Group regulatory requirements, the Prudential Group applies an economic framework to its management of capital. Economic capital provides a realistic and consistent view of the Group's capital requirements, allowing for diversification benefits.

At the Fund level, the FSA rules which govern the prudential regulation of insurance form part of the Prudential Sourcebook for Insurers, the General Prudential Sourcebook and Interim Prudential Sourcebook for Insurers. Overall, the net requirements of the General Prudential Sourcebook are intended to align the capital adequacy requirements for insurance business more closely with those of banking and investment firms and building societies, for example, by addressing tiers of capital, rather than looking at net admissible assets. An insurer must hold capital resources equal at least to the Minimum Capital Requirement (MCR).

The Prudential Sourcebook for Insurers also contains rules on Individual Capital Assessments. Under these rules and the rules of the General Prudential Sourcebook all insurers must assess for themselves the amount of capital needed to back their business. If the FSA views the results of this assessment as insufficient, it may draw up its own Individual Capital Guidance for a firm, which can be superimposed as a requirement.

Under FSA rules, insurers with with-profits liabilities of more than £500 million must hold capital equal to the higher of the MCR and the Enhanced Capital Requirement (the "ECR"). The ECR is intended to provide a more risk responsive and "realistic" measure of a with-profit insurers capital requirements, whereas the MCR is broadly speaking equivalent to the previous required minimum margin under the Interim Prudential Sourcebook and satisfies the minimum EU Standards.

Determination of the ECR involves the comparison of two separate measurements of the firm's resources requirement, which the FSA refers to as the "twin peaks" approach. The two separate peaks are:

(i) the requirement comprised by the mathematical reserves plus the "Long-Term Insurance Capital Requirement" (the "LTICR"), together known as the "regulatory peak"; and

(ii) a calculation of the "realistic" present value of the insurer's expected future contractual liabilities together with projected "fair" discretionary bonuses to policyholders, plus a risk capital margin, together known as the "realistic peak".

Available capital of the Fund of £190m (2011: £251m) represents the excess of assets over liabilities on the FSA realistic basis. These amounts are shown before deduction of the risk capital margin (RCM) which is £98m (2011: £240m) at 31 December 2012. The FSA's basis of setting the RCM is to target a level broadly equivalent to a Standard & Poor's credit rating of BBB and to judge this by ensuring there are sufficient assets to absorb a 1 in 200 year event. The RCM calculation achieves this by setting rules for the determination of margins to cover defined stress changes in asset values and yields for market risk, credit risk and termination risk for with-profits policies.

The Fund has discretion in its management actions in the case of adverse investment conditions. Management actions encompass, but are not confined to, investment allocation decisions, levels of reversionary bonuses, crediting rates and total claim values. To illustrate the flexibility of management actions, rates of regular bonus are determined for each type of policy primarily by targeting them at a prudent proportion of the long-term expected future investment return on the underlying assets. The expected future investment return is reduced as appropriate for each type of policy to allow for items such as expenses, charges, tax and shareholders' transfers. However, the rates declared may differ by product type, or by date of payment of the premiums or date of issue of the policy, if the accumulated annual bonuses are particularly high or low relative to a prudent proportion of the achieved investment return.

When target bonus levels change, the Fund's board has regard to the overall financial strength of the long-term fund when determining the length of time over which it will seek to achieve the amended product target bonus level. In normal investment conditions, the Fund expects changes to regular bonus rates to be gradual over time and changes are not expected to exceed one per cent per annum over any year. However, discretion is retained as to whether or not a regular bonus is declared each year, and there is no limit on the amount by which regular bonus rates can be changed.

As regards smoothing of maturity and death benefits, in normal circumstances pay-out values on policies of the same duration are not expected, from one year to the next, to go up or down more than 10% for single premium policies and up or down by more than 7% about a long-term trend for annual premium policies, although some larger changes may occur to balance pay-out values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years) and in such situations the Fund's board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders.

For surrender benefits, any substantial fall in the market value of the assets of the with-profits sub-fund would lead to immediate changes in the application of MVRs for accumulating with-profits policies, firstly to increase the size of MVRs already being applied and, secondly, to extend the range of policies for which an MVR is applied.