Direct Line Group

# Improving our customer experience

Annual Report & Accounts 2014

# **Improving** our customer experience

Our aspiration is to be the leading personal and small business general insurer in the UK. That is why our customers are at the heart of everything we do.

Our performance has enabled us to invest in improving experiences for them. To be the best, we will continue expanding our capabilities, enhancing our products, and improving our services.

These case studies reveal how we are improving our customer experience.

**Making** it easier for our customers

Page 2

**Expanding** our customer offering

Page 14

**Improving** our customer support

Page 24

Direct Line Group (the **"Group"**) is Britain's leading personal motor and home insurer[1].

We operate a multi-brand, multi-product and multi-distribution channel business that covers the majority of customer segments for personal lines general insurance and small and medium-sized enterprise commercial insurance. Our brands offer motor, home, rescue, pet, travel and commercial products.

Read more about our strategy on page 16


## Strategic report

4 Group highlights
6 Group at a glance
8 Business model
10 Chairman's statement
12 Chief Executive Officer's review
16 Our strategy
26 Our key performance indicators
28 Risk management
32 Corporate social responsibility
36 Operating review
40 Finance review

## Governance review

50 Chairman's introduction
52 Board of Directors
54 Executive Committee
55 Corporate governance report
61 Committee reports
71 Directors' remuneration report
94 Directors' report

## Financial statements

98 Contents
99 Independent auditor's report
103 Consolidated financial statements
108 Notes to the consolidated financial statements
161 Parent Company financial statements
163 Notes to the Parent Company financial statements

## Other information

167 Additional information
169 Glossary
171 Forward-looking statements disclaimer
172 Contact information


Visit our website or download our app
**www.directlinegroup.com**

Note:
1. Ranked number one by total in-force policies in the motor and home markets combined, including partner brands: RBS, NatWest, Nationwide and Prudential © GfK NOP Financial Research Survey (FRS) 6 months ending December 2014, 12,973 adults interviewed for motor insurance and 12,181 for home insurance.

We sell directly over the phone, internet and through the UK's main price comparison websites
Improving customer interaction through optimised websites for smartphones and tablets
Customers are able to get live updates on the progress of their motor repair

# **Making** it easier for our customers

We aim to improve the efficiency and effectiveness of our distribution. How? By focusing on customer value and our digital capability to enable us to provide straightforward products that meet our customers' needs.

We rolled out new websites for the Group's motor brands to make it easier for customers to purchase a policy. We also introduced a new customer service web chat channel, making it easier for customers to speak to us while on the go.

81%

increase in Motor insurance purchased on a smartphone[1]

1,800

web chats per day[2]

Notes:
1. Compared to 2013
2. Average of 'quote and buy' and service web chats for the six months to 31 December 2014 for the Group's own brands: Direct Line, Churchill and Privilege for motor and home products.

# Advancing our strategic plans

We achieved a good set of results and hit our financial targets while continuing to deliver our strategic priorities.

## 16.8%
Return on tangible equity[1]

Ongoing[2] and International

2013: **16.0%**
2012: **11.5% (pro forma 13.4%)**

Our financial target
15%

## 95.0%
Combined operating ratio[3]

Ongoing operations[2]

2013: **95.2%**
2012: **98.8%**

Our financial target
95% to 97% in 2014

## £973.9m
Total cost base[4]

Ongoing and International

2013: **£1,031.9m**
2012: **£1,136.8m**

Our financial target
Approximately £1,000m in 2014

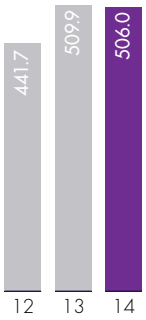
## Financial highlights

### Gross written premium – ongoing operations[2] (£m)

£3,099.4m

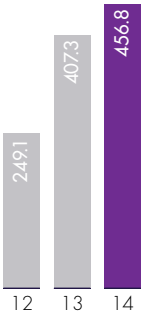
### Operating profit – ongoing operations[2] (£m)

£506.0m




### Profit before tax – continuing operations[5] (£m)

£456.8m




Notes:

1. Return on tangible equity (**"RoTE"**) is adjusted profit after tax from ongoing operations and the International division (discontinued operations) divided by the Group's average tangible shareholders' equity. Profit after tax is adjusted to exclude the Run-off segment, restructuring and other one-off costs and gain on disposal of subsidiaries, and is stated after charging tax (using the UK standard tax rate of 21.5%; 2013: 23.25%). For 2012, pro forma RoTE is based on the return on tangible equity, but assumes that the capital actions taken by the Group prior to the initial public offering (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.
2. Ongoing operations include the Group's ongoing divisions: Motor, Home, Rescue and other personal lines, and Commercial. It excludes the International division which is classified as discontinued operations, the Run-off segment and restructuring and other one-off costs.
3. Combined operating ratio is the sum of the loss, commission and expense ratios. The ratio is a measure of the amount of claims costs, commission and expenses compared to net earned premium generated.
4. Operating expenses and claims handling expenses from ongoing operations and International. It excludes the Run-off segment and restructuring and other one-off costs.
5. For 2014 and 2013, continuing operations includes all activities other than International.

# Highlights

## Financial highlights

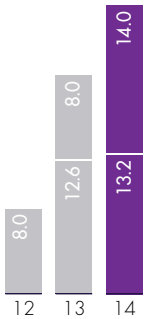
- Gross written premium from ongoing operations 3.8% lower for 2014 compared with 2013, reflecting disciplined approach to underwriting in Motor and Home operations; trends improved during the year
- Combined operating ratio from ongoing operations of 95.0% for 2014, an improvement of 0.2 percentage points on 2013 (95.2%) including stable contribution from prior-year reserve releases of £397.6 million (2013: £395.8 million)
- Stable operating profit from ongoing operations of £506.0 million for 2014 (2013: £509.9 million); while total Group statutory profit before tax for continuing operations rose 12.2% to £456.8 million (2013: £407.3 million)
- Return on tangible equity of 16.8% for 2014 (2013: 16.0%)
- 4.8% increase in final[1] dividend per share to 8.8 pence per share and second special interim dividend of 4.0 pence per share. Total dividends for 2014 of 27.2 pence per share (2013: 20.6 pence per share)

## Strategic and operational highlights

- All initial public offering and 2014 published targets either met or exceeded: Group combined operating ratio; Commercial combined operating ratio; total cost base; and return on tangible equity
- Ongoing investment in capability supporting profitability across Group with all divisions now making a material contribution
- Announced binding agreement for the sale of International division for €550 million (£430.1 million[2])
- Continued active capital management with 24.6% of initial public offering price already returned to shareholders, rising to 31.9% when the final[1] and second special interim dividends are included. This excludes the expected return of capital associated with the sale of the Group's International division
- Focus on UK reaffirmed with clear strategic aim of making insurance much easier and better value for customers

### Dividend per share[1] – total Group (pence)

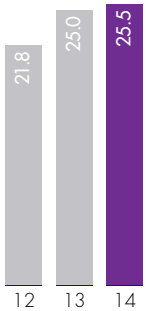
27.2p




12.0 pence pro forma full year dividend for 2012

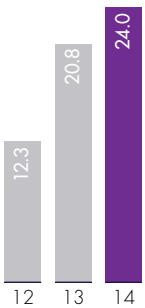
### Adjusted earnings per share – diluted[3] – ongoing and International (pence)

25.5p




### Earnings per share – basic[4] (pence)

24.0p




Notes:

1. The Board has resolved this year to pay an interim dividend in lieu of a final dividend, see page 45, and references in this document to 'final dividend' for 2014 are to be construed as references to this interim dividend. In this document the second special dividend is referred to separately from the final dividend. This enables more appropriate comparison of the 2013 final dividend. Both the second special interim dividend and the final dividend will be paid together as one payment. For 2012, pro forma full-year dividend is based on the final dividend of 8.0 pence per share, representing two-thirds of the full-year payout ratio.
2. Cash sale proceeds received in Euros have been converted to Pound Sterling using the rate within the designated foreign currency hedge contract.
3. Adjusted earnings per share – diluted, includes ongoing operations and the International division (discontinued operations) and excludes the Run-off segment, restructuring and other one-off costs, and the gain on disposal of subsidiaries (using UK standard tax rate of 21.5%; 2013: 23.25%).
4. For 2014 and 2013, basic earnings per share is presented for continuing operations and excludes discontinued operations. 2012 is for total Group.

# Protecting our customers

We have multiple brands, products and distribution channels. Each enables our customers to choose the right cover to protect their cars, homes, holidays, businesses and pets.

## Our brands

**Direct Line** has maintained the heritage of its brand in the UK by selling products direct to customers by phone and internet only. We target customers with a high brand affinity, focusing on a quick and straightforward customer experience.

www.directline.com

**Direct Line for Business** is an extension of the Direct Line brand. It is our direct commercial insurance brand for small businesses in the UK that have straightforward commercial insurance requirements.

www.directlineforbusiness.co.uk

**Churchill** is a household name with products marketed in the UK by phone and internet, including by price comparison websites (**"PCWs"**). We target customers with a high brand affinity and that value the need for support.

www.churchill.com

**Privilege** targets customers who mainly buy through PCWs. We focus on providing a quick customer experience at the best price.

www.privilege.com

**Green Flag** is our roadside rescue and recovery product, which is sold both as a standalone service and an additional optional product alongside motor insurance.

www.greenflag.com

**NIG** is our specialist commercial insurance brand, focused on small and medium-sized enterprises (**"SMEs"**) in the UK. We sell our products through brokers, including an in-house intermediary that arranges RBS and NatWest commercial insurance[1].

www.nig.com

**Brand Partners** is the business-to-business arm of the Group. We specialise in providing personal lines insurance, and roadside rescue and recovery products to some of the UK's well-known brands.

www.brand-partners.co.uk

Note:
1. The Royal Bank of Scotland Group plc, including National Westminster Bank plc.

# Our divisions

## Personal

### Motor

We are Britain's leading personal motor insurer, with a 13.1% share of in-force policies[1], mainly represented through our highly recognised brands, Direct Line, Churchill and Privilege, and through partners. We insure around one in seven cars on the road, representing 3.7 million in-force policies.

£1,342.0m
Gross written premium

3,672
In-force policies (thousands)

96.2%
Combined operating ratio

£297.1m
Operating profit

For more information, see page 36

### Home

We are one of Britain's leading home insurers, with a 16.7% share of in-force policies[1]. We reach our customers by selling home insurance products through our brands Direct Line, Churchill and Privilege as well as through our partners Sainsbury's Bank, RBS, NatWest, Nationwide Building Society and Prudential.

£898.6m
Gross written premium

3,526
In-force policies (thousands)

92.7%
Combined operating ratio

£113.9m
Operating profit

For more information, see page 37

### Rescue and other personal lines

We are one of the leading providers of rescue and other personal lines insurance in the UK[2,3] with 8,592 thousand in-force policies. This includes providing roadside assistance and recovery for customers through Green Flag, the UK's third-largest roadside recovery provider[2]. We also offer customers protection for their pets and holidays and we are the third largest insurer in the UK for these insurance products[3].

£371.8m
Gross written premium

8,592
In-force policies (thousands)

92.0%
Combined operating ratio

£48.0m
Operating profit

For more information, see page 38

## Commercial

We protect small and medium-sized enterprises through our own brands, NIG, Direct Line for Business and Churchill, plus RBS and NatWest. NIG sells its products exclusively through independent brokers operating across the UK. Direct Line for Business provides business, van and landlord insurance products. Churchill sells van insurance direct and via PCWs.

£487.0m
Gross written premium

611
In-force policies (thousands)

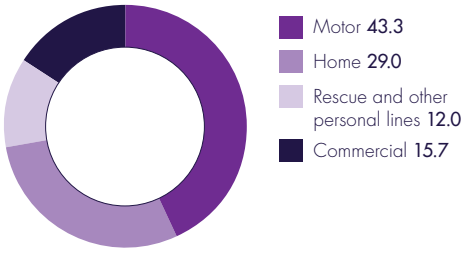
98.8%
Combined operating ratio

£47.0m
Operating profit

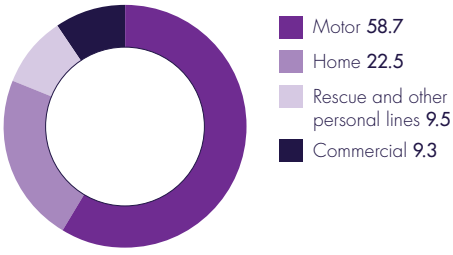
For more information, see page 39

# Our performance – ongoing operations[4]

### Gross written premium[4]
(%)




### Contribution to operating profit[4]
(%)



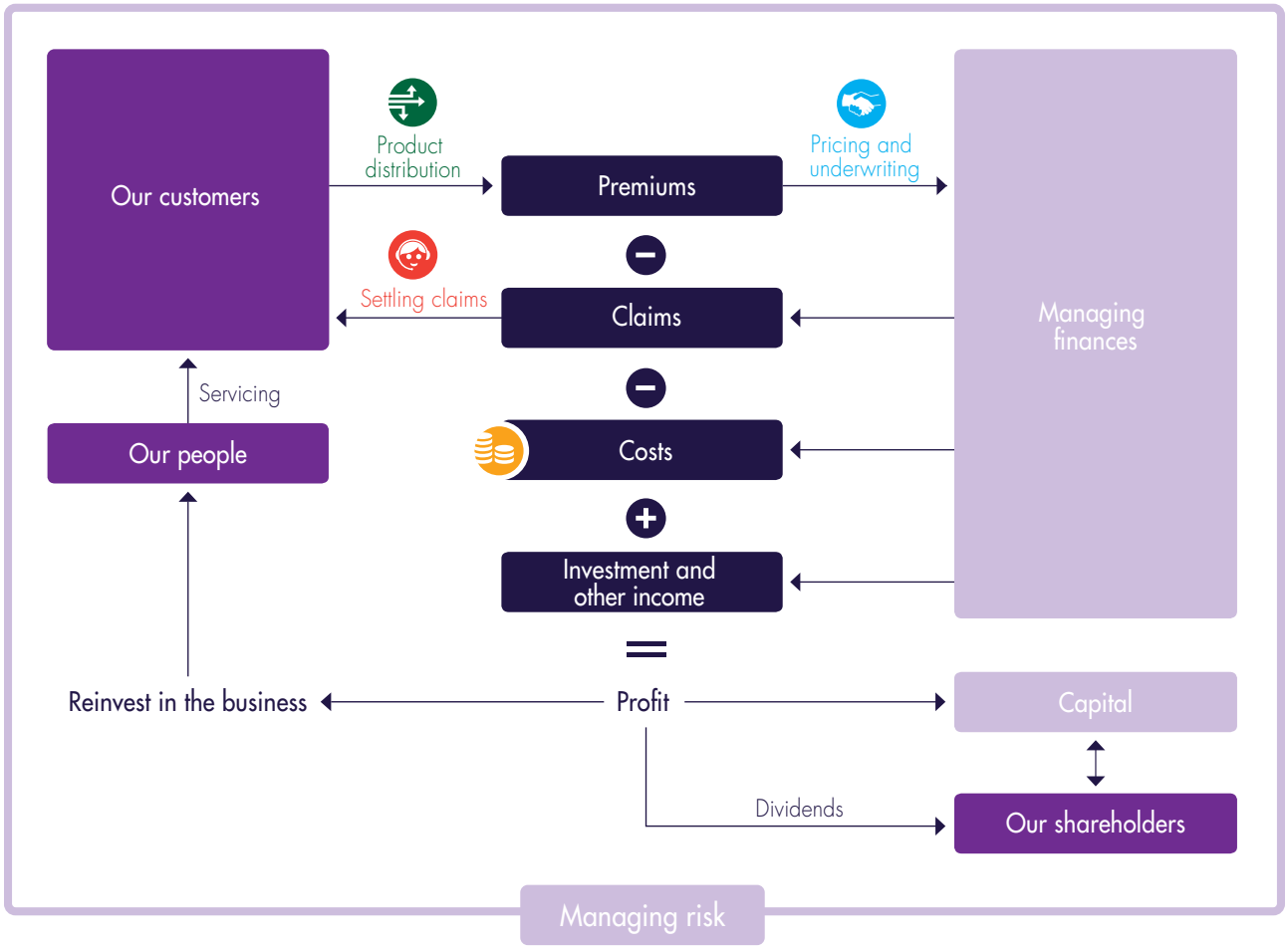

Notes:
1. Ranked by total in-force policies in the motor and home markets, including partner brands: RBS, NatWest, Nationwide and Prudential © GfK NOP Financial Research Survey (FRS) 6 months ending December 2014, 12,973 adults interviewed for motor insurance and 12,181 for home insurance.
2. Mintel Vehicle Recovery – UK, September 2014
3. Mintel Pet Insurance – UK, August 2014 and Mintel Travel Insurance – UK, February 2014
4. See note 2 on page 4

# **Creating** value for our customers

Our multi-brand, multi-product and multi-distribution channel business offers different propositions to distinct customers. We believe this approach will enable us to generate value for customers and sustainable returns for our shareholders.

Read more about our key performance indicators that measure the effectiveness of our business model on page 26

Read more about our risk management on page 28



## Generating value for our customers through our people

### Our customers

Customers are at the heart of our business model and we have a clear mission to make insurance much easier and better value for them. We aspire to give them products that best suit their needs as well as provide exceptional service throughout their relationship with us. We also strive to adapt to their changing needs. From the moment customers select our products, to the time they claim or need to resolve an event, we treat every step of the customer journey as an opportunity to provide excellent service and outcomes.

### Our people

Everyone – from our front-line staff to employees in support and central functions – plays a part in ensuring we meet customers' needs. Without our people, we could not generate value for customers and sustainable returns for our shareholders.

### Our shareholders

Our shareholders are a crucial part of our business model. They invest in the business expecting to achieve returns. We aim to deliver value for our shareholders by generating sustainable business profits. We reinvest this profit in the business or distribute it to shareholders as dividends.

## Our focused processes

### Product distribution

We aim to make our products easy to access and give our customers what they are looking for. We want to ensure customers are appropriately covered when unexpected events happen.

Customers can purchase products online, including through PCWs, by phone, and indirectly through partners and, in our Commercial business, via brokers. Each brand provides products targeted at one or more insurance segments: motor, home, rescue, pet, travel and commercial. By tailoring the mix of distribution channels for each product, we offer customers a combination of brands, products and services that best suit their needs.

### Pricing and underwriting

Our business has operated on a large scale for almost 30 years, giving us a deep insight into the risks we underwrite. This insight enables us to make our pricing more accurate. It also allows us to invest substantially in data and achieve increased efficiencies. Again, this means we can more accurately set the right price for the risks we underwrite.

### Settling claims

Customers truly recognise the value of their policy when they make a claim. We aim to settle claims as quickly and easily as possible through active engagement with our customers. This helps us demonstrate the value of our products and services, and manage our claims costs.

## Our disciplined approach

### Managing finances

We seek to ensure our business is well governed and controlled. We manage our finances carefully and we balance this with targeting a suitable and sustainable return to our shareholders.

We hold assets that exceed our expected liabilities in the form of capital. This absorbs unexpected losses that might occur and helps us meet our regulatory capital requirements.

We ensure we have sufficient funds to pay customer claims by adopting a conservative approach to claims reserving. This may result in releases from these reserves contributing to our annual profit.

### Managing risk

We ensure our products meet regulatory standards and that customers understand what they are purchasing from us. We also aim to price our policies prudently and invest our assets appropriately to minimise any potential losses.

We transfer significant insurance risk through reinsurance in the normal course of business and external experts regularly review our insurance claims reserves. We mitigate risks by implementing our Group policies and minimum standards. These are reviewed regularly to ensure we are in line with the risk appetite set by the Board.

# Delivering on our targets

"The Board is focused on providing robust oversight of Direct Line Group, including a substantial programme of investment in improving our customers' experience, and aiming to create long-term value for our shareholders."

**Mike Biggs**
Chairman

In this report, I would like to consider Direct Line Insurance Group plc's (the **"Company"**) achievements from before the initial public offering (**"IPO"**) in October 2012 to where we are today, including our successful separation from the Royal Bank of Scotland Group (**"RBS Group"**) in early 2014.

Before the IPO, the Board set robust and stretching financial and business targets for the Group. We have met, and in some cases, exceeded these targets. This includes delivering a return on tangible equity[1] of 15%. In both 2014 and 2013, we achieved returns above this level, of 16.8% and 16.0% respectively. Your Board set an initial gross cost savings target of £100 million for 2014. We subsequently increased the ambition to deliver a total cost base[2] of approximately £1,000 million, which I am pleased to say management achieved in 2014. Our Commercial division was tasked with delivering a combined operating ratio of less than 100%; it has successfully met this challenge.

Throughout this period we stated that the Group would target holding capital in the range of 125% and 150% of risk-based capital sufficient to maintain a credit rating in the 'A' range. It has consistently remained at the upper end of this range. Since the IPO, we have declared cumulative dividends, including special interim dividends, of 55.8 pence per share. This is equivalent to 31.9% of the IPO price.

These achievements contributed to a strong share price performance and supported another milestone of 2014 with the admission of the Company into the FTSE 100 on 22 September 2014. The increase in the Company's market capitalisation positively reflects investor confidence in our business. An increase of 16.7% in the share price to 291.3 pence across the year to 31 December 2014 together with dividend payments provided a total shareholder return (**"TSR"**) of 28.7% for the year.

## Strategy update

We plan to enhance the way we interact with our customers and the ease with which their claims are handled. Your Board has overseen and challenged these investment programmes with the aim that the business delivers appropriately for our customers' evolving requirements and on a financially acceptable basis for our shareholders.

Early in the year we carried out a strategic review of our International division. We concluded that a disposal would be likely to generate the most value to the Group. On 25 September 2014, we announced a binding agreement with Mapfre, S.A. for the sale of this division for €550 million (£430.1 million[3]). Completion of the sale is conditional on receiving one outstanding regulatory approval and is currently expected to complete in the first quarter or failing which in the second quarter. Your Board believes this is a good result for all our stakeholders, including providing excellent value for shareholders.

We have also taken the opportunity during 2014 to review and rearticulate our strategy. This strategy has at its heart our mission to make insurance much easier and better value for customers.

Notes:
1. See note 1 on page 4
2. See note 4 on page 4
3. See note 2 on page 5

## Our governance principles

### Leadership
Your Board challenges strategic proposals, performance delivery and the responsibilities of management, seeking to ensure that decisions are of the highest standard.

Read more on page 55

### Effectiveness
Your Board's performance is reviewed annually in an effectiveness review. This considers our effectiveness, individually, as a Board and in our Committees.

Read more on page 57

### Accountability
Your Board provides shareholders with an assessment of the Group's position and prospects. It has overall oversight of the Group's risk management and internal system of control.

Read more on page 28 and 59

### Remuneration
Your Board, through the Remuneration Committee, is responsible for the remuneration arrangements of the Executive Directors and senior executives.

Read more on page 71

### Engagement
Maintaining strong relationships with our shareholders is important to support our aims. The Board maintains regular dialogue with our shareholders.

Read more on page 60

## Dividend and capital management
Your Board regularly reviews the level of capital held by the Group. Ahead of Solvency II implementation on 1 January 2016, we currently believe that it is appropriate to maintain this at the upper end of the targeted risk-based capital-coverage range of 125% to 150%. The Group's Solvency II planning is on track.

The Board has resolved to pay an interim dividend of 8.8 pence per share in lieu of a final dividend. This represents an increase of 4.8% on the full-year regular[1] dividend for 2013.

The Company paid a special interim dividend of 10.0 pence per share on 12 September 2014 and on 2 March 2015 resolved to pay a further special dividend of 4.0 pence per share. These dividends reflect the build up of surplus capital which the Board believes is appropriate to return to shareholders. On the completion of the sale of the International division, your Board currently expects to announce an additional return of capital, reflecting substantially all the net proceeds of the sale. This return of capital will be conditional on shareholders approving a share consolidation designed to neutralise the effect on the share price of the return of capital. Further details of the return of capital and share consolidation will be communicated to shareholders in due course.

## Culture
Your Board is committed to embedding a values-driven culture across the Group. Our values are 'Do the right thing', 'Aim higher', 'Work together', 'Take ownership', 'Say it like it is' and 'Bring all of yourself to work'. As stated in our Code of Business Conduct, the Board also requires all employees to adhere to the highest possible standards of professional and ethical conduct. You can read more about our values and code on page 50.

## Our relationship with RBS Group
On 27 February 2014, RBS Group sold substantially all of its remaining shareholding in the Company[2]. Following this, and in line with the Relationship Agreement between the Company and RBS Group, Mark Catton, RBS Group's nominated Director, stepped down from the Board on 7 March 2014.

Under a Transitional Services Agreement, RBS Group continues to provide certain services to Direct Line Group, including IT infrastructure. During the year, we progressed substantially in rolling out our new data centres with Capgemini and deploying new voice and desktop tools. These are key milestones to migrate our IT infrastructure from RBS Group systems to our own environment.

## Board changes and effectiveness
There have been several changes to the composition of the Board and Committees during the year. As noted above, Mark Catton stepped down on 7 March 2014 and I would like to thank him for his excellent contribution to the Board and wish him well for the future.

Following a review of the Board's balance of skills, knowledge and experience, Sebastian James, Group Chief Executive of Dixons Carphone plc, joined the Board on 28 August 2014 as a Non-Executive Director. I am delighted to welcome Sebastian. The Board will benefit from his knowledge of customer service in a digital retail market.

On 30 September 2014, Sebastian was appointed as a member of the Remuneration Committee and the Corporate Social Responsibility (**"CSR"**) Committee. Jane Hanson retired as Chair of the CSR Committee but will continue as a member. Clare Thompson was appointed as Chair of the CSR Committee and retired as a member of the Remuneration Committee. My thanks go to Jane for her role as Chair of the CSR Committee and particularly for overseeing the establishment of our CSR agenda. You can read more about our Committees from page 61.

## Summary
We are fortunate to have hardworking and talented employees. Their commitment to customers and pride in what they do never ceases to impress me. I thank every one of them for their contributions last year and into the next.

**Michael N Biggs**
Chairman

Notes:
1. The regular dividend includes the interim and final dividends, it excludes special interim dividends.
2. RBS Group retained a number of Ordinary Shares in the Company to satisfy long-term incentive plan awards granted by it to Direct Line Group management.

# **Investing** in the future of our business

"We have built solid foundations for our business and are continuing to invest in our future. As we head into the next phase of our journey, I am excited by the focus and energy of our people to deliver even further success."

**Paul Geddes**
Chief Executive Officer

## Overview of financial performance

I am pleased with our performance in 2014 and proud of our people's focus and dedication. Through our efforts, we achieved our financial targets and progressed strongly towards our strategic priorities. Against the backdrop of a highly competitive marketplace, we maintained underwriting discipline, helping us to deliver a stable operating profit from ongoing operations[1] of £506.0 million compared to 2013 (£509.9 million). However, a reduction in restructuring costs helped deliver an increase in profit before tax to £456.8 million (2013: £407.3 million).

The motor insurance market remained highly competitive with further premium deflation at the start of the year. Gross written premium trends improved during the year, increasing 0.4% in the fourth quarter compared with 2013. We continued to make choices to optimise value and prioritise underwriting profit over volume growth, which meant gross written premium for the Motor division of £1,342.0 million reduced by 5.6% and in-force policies reduced by 2.4%, compared with 2013.

The home insurance market also experienced further new business premium deflation during 2014, with gross written premium of £898.6 million, 4.7% lower, as in-force policies reduced by 5.2%, compared with 2013. This was mainly driven by our partnership business, reflecting changing distribution trends. That said, the benefits from recent pricing and claims initiatives allowed us to increase our competitiveness while keeping the retention of renewing policies at good levels.

We have also met or beaten all of the published targets set since the IPO. We achieved a combined operating ratio[2] (**"COR"**) of 95.0% (2013: 95.2%), which was within our target range of 95% to 97% for ongoing operations. This contributed to a return on tangible equity[3] of 16.8%, ahead of our long-term target of 15.0%. Our Commercial business achieved a COR of 98.8%, beating its sub-100% COR target. Our continued focus on improving operational efficiency enabled us to deliver further cost reductions across the business, beating our cost target[4] of £1,000 million in 2014.

During the first half of 2014 we initiated a strategic review of our International division. Although the review did confirm the division's strong market positions, we decided to explore a potential disposal of these operations. In September, we announced a binding agreement for the sale of our International division to Mapfre, S.A. for total cash sale proceeds of €550.0 million (£430.1 million[5]). We believe this is a good result for all our stakeholders, as it provides excellent value for shareholders, while offering our customers and colleagues stability and opportunity.

## Investing in our future

We have a growing expectation that technology will profoundly change many aspects of our customers' needs, and we are determined to be a leader in meeting these new demands. We have continued to invest in our infrastructure, including work on the next generation of customer systems and progressing with the

Notes:
1. See note 2 on page 4
2. See note 3 on page 4
3. See note 1 on page 4
4. See note 4 on page 4
5. See note 2 on page 5

migration of our IT systems from RBS Group. While this project is not complete and has been challenging, I am pleased to say we have made considerable headway while ensuring the new systems can achieve high levels of operational performance. We are on track to complete the migration in 2015.

Recognising that customers are transacting on the go, we have optimised our motor websites for smartphone and tablet devices. This has made it easier for customers to buy policies from us by significantly improving the 'quote and buy' customer journey. We have seen an 81% increase in Motor insurance purchased on a smartphone this year. The new systems have also enhanced analytics, which gives us further insight into customer browsing and purchasing behaviour, enabling us to tailor our websites to their needs.

Additionally, we have rolled out a number of initiatives that make it easier for customers to claim. In Home, we have enabled customers to upload photos and videos to help assess their claim.

We have also invested in our pricing abilities to ensure we continue providing value to customers. Through a series of pricing projects on Motor, we have enhanced and fine-tuned our trading capabilities, especially through the PCW channel. In telematics, we launched a new self-install product, which provides a robust, cheaper alternative to black-box technology. We are already using the data collected from the new products to improve our pricing sophistication when renewing telematics policies.

We have also refreshed the product offering of our Direct Line brand, which incorporates a new advertising campaign. We want customers to trust us to deliver on service and take the hassle out of claiming, while still offering great value for money. The new advertising is proving popular with customers and we have already seen a positive impact on desired key brand metrics. The TV advertising in particular is performing significantly ahead of all insurance sector benchmarks, across measures such as involvement and persuasion.

Alongside these improvements, we have continued working hard to improve our customer service across the Group. We have also introduced new measures to monitor customer satisfaction, which will help us improve our customers' experience, as well as recognise and reward great service. We know we are heading in the right direction, but there is more we can do to meet our customers' needs. This will be a key focus for us in 2015 as we embed additional customer initiatives.

## Investing in our people

We have continued to make improvements throughout our organisation. Our people are driving these changes, simplifying processes and working as a community to deliver the products and services our customers expect. Our people sit behind our success, therefore we put great effort in recognising outstanding performance. The Chief Executive Awards are among the key initiatives. These awards identify and recognise the best examples of our values across the business as well as diversity and community involvement. Over 2,000 of our people were nominated for the special contributions they have made to the business. In recognition of the progress we have made, we plan to give our UK employees £400 of free shares, in addition to the shares that were awarded at the time of the IPO. This gives everyone a chance to share in the success of our business.

## Regulatory environment

The regulatory landscape continues to be dynamic, especially in the UK motor insurance market. This year, the Financial Conduct Authority (**"FCA"**), the Competition and Markets Authority (**"CMA"**) and the Ministry of Justice (**"MoJ"**) have issued further reviews and remedies.

Overall, the Group continues to support good conduct and proportionate reforms which will deliver better consumer outcomes and a level playing field across the industry.

## Strategic priorities for 2015

We know that our environment is ever-changing, we must therefore ensure that our strategy is aligned to this evolution. We know our strategy supports our aspiration to be the leading personal and small business general insurer in the UK and this means making insurance much easier and better value for our customers. We have a set of core objectives that we believe will help us to deliver this ambition, read more on Our strategy on page 22.

## Outlook

The UK motor and home markets remain highly competitive with recent market conditions characterised by periods of market price deflation and of stability. Early 2015 has seen some additional, potentially seasonal, market pressure in motor and broad stability in the home market.

Against this backdrop we will continue to adopt a flexible, but disciplined, approach to managing the trade-off between margin and volumes. Meanwhile we are investing in building future capability and continue to identify opportunities to improve efficiency.

For 2015, we expect to achieve a combined operating ratio in the range of 94% to 96% for ongoing operations after normalising for claims from major weather events. The range reflects uncertainty surrounding claims inflation versus market pricing in motor.

This year, we have built solid foundations for our business and are continuing to invest in our future. As we head into the next phase of our journey, I am excited by the focus and energy of our people to deliver even further success. I would like to thank our people for always helping and supporting our customers, while embracing continuous change. This drive will make our business the best it can be.

I am also thankful for our investors' ongoing support as we continue improving our business and delivering further benefits for customers, shareholders and wider stakeholders.

**Paul Geddes**
Chief Executive Officer

Read more about our strategy on page 16

DrivePlus gives drivers instant access to their driving data via an app
Telematics encourages better driving
DrivePlus enables our customers to install the device themselves

# Expanding our customer offering

Drivers can review their driving straight after each journey

**As telematics continues to gather pace, our expertise and extensive data means we are well positioned to take advantage of this growing market.**

The launch of our telematics self-install product, DrivePlus Plug-in, offers customers a convenient and easy way to be rewarded for safer driving.

## 56%

of under 21s now taking up telematics[1]

## 125

million miles of telematics data collected

Note:
1. Direct Line new policies taken out by under 21s over the phone in 2014

# Delivering our key priorities

## We continue to transform our business and progressed on our key strategic priorities during 2014.

Our achievements were far-reaching. We proceeded with changing our operations and customer experience, while successfully hitting our financial targets.

### Our key strategic priorities

We have been reporting on our performance against five strategic priorities since our listing as a public company in 2012. In this Report, we continue reporting against these areas and explain our 2014 progress in this section.

Early in 2014, we carried out a strategic review of our International division. The review concluded that although these operations occupied strong positions, a disposal would be likely to generate the most value to the Group. In September, we announced the sale of the division and as a result of this, progress against our fifth strategic priority now relates solely to Commercial. You can find more details about the performance of the International division in the Finance review on page 44.

### Our strategy is evolving

As we develop our business in a constantly changing environment, our strategy also needs to evolve. We have reviewed the overall Group strategy alongside the strategic priorities. You can find the results of this review on page 22.

**Read more** about our progress on the following pages

## Our key strategic priorities

### Distribution

We have improved customers' experience while differentiating the Direct Line customer proposition.

### Pricing

We delivered over 30 major pricing initiatives.

### Claims

We have continued improving our claims service.

### Costs

We reduced our cost base by 5.6% in 2014.

### Commercial

We delivered a combined operating ratio below 100%.

# Distribution

## We have improved our customers' experience while differentiating the Direct Line customer proposition.

We aim to improve our distribution efficiency and effectiveness by focusing on digital capability and customer value.

We seek to understand customers' requirements and provide products that meet their needs, offer good value and are straightforward to purchase.

We employ a multi-distribution channel model. We aim to optimise the mix of these channels for each of our products and brands. This includes selling products directly by phone and internet, including through all of the UK's major PCWs, and via selected partners.

### Progress in 2014

During 2014, we progressed significantly in making it easier for customers to buy from us through the launch of new websites for Motor. We have re-engineered and optimised the 'quote and buy' journey whether customers are using personal computers, smartphones or tablets.

We further differentiated the Direct Line customer proposition in 2014 with a focus on improving claims service. This proposition was supported by a new advertising campaign.

We have also continued building our telematics portfolio, with 38,000 in-force policies at year end. This growth has been accelerated by the launch of a self-install device during the year.

**94%**

of customers rate our sales and service consultants as good or excellent[1]

## Distribution performance

**1,800**

web chats per day[2]

**56%**

telematics take-up by under 21s[3]

**81%**

increase in Motor insurance purchased on a smartphone compared to 2013

Notes:

1. Group own brands and strategic partners: Direct Line, Churchill, Privilege, Green Flag, Sainsbury, RBS, NatWest, Prudential, Nationwide, Citroen and Peugeot © NICE Systems, MyCustomer – Fizzback, year ending 31 December 2014, sample size 472,828 responses for motor, home, pet, travel and rescue customers. 'Good or Excellent' represented by scores of 7 to 10 out of 10
2. Average of 'quote and buy' and service web chats for the six months to 31 December 2014
3. Direct Line new policies taken out by under 21s over the phone in 2014

# Pricing

## We delivered over 30 major pricing initiatives.

We aim to leverage our substantial data to provide leading technical and market pricing.

By enhancing our pricing capabilities, we can improve the way we assess the risks we are willing to accept and price them more accurately. Our customers benefit through more accurate pricing.

### Progress in 2014

During 2014, we made major progress in our ambitions around pricing sophistication. We have delivered over 30 programmes which relate to technical and market pricing, and have contributed to our underwriting performance.

Additionally in Motor, we have started using telematics-generated data to inform pricing decisions for telematics customers. This gives us another rich and valuable data source, allowing us to reward customers for better driving in ways traditional rating factors would not recognise.

### Our pricing projects

30

**Major pricing initiatives delivered in 2014**

Our projects are significantly enhancing our pricing capabilities and helping us offer more accurate pricing, including on price comparison websites.

### Pricing performance

81%

**Home own brands retention rate**

80%

**Motor own brands retention rate**

40%

**Differential in pricing from telematics data[1]**

Note:
1. Price differential in addition to traditional rating factors when telematics data is considered.

# Claims

## We have continued improving our claims service.

We aim to improve our performance through efficient and effective claims management.

We have fundamentally redesigned our claims operating model with simpler processes in fewer sites. This gives a better customer experience through our people having more control. By managing most claims through our own professional loss adjusters and repairing cars through our own accident repair centres and network garages, we aim to ensure customers benefit from our scale and expertise.

We continue to invest in providing customers with a reliable and straightforward claims service that is transparent at each step.

### Progress in 2014

We continued building on our claims services by using smartphone technology to improve our customers' claims experience. Straightforward home claims can now be advised via photos and video taken by smartphone, helping to speed up settlement and reduce fraud.

We have also continued improving the claims proposition through using our supply chain more effectively. Direct Line customers now benefit from faster car repair times, the offer of sourcing a replacement car in the event of a total loss, and replacements ready in eight hours for some household goods.

### Our fraud performance

**2.6times**

detection level ahead of the market[1]

### Our claims processes

**158,000**

Vehicles repaired by our accident repair centres and network garages

**80%**

Customer uptake to upload digital evidence[2]

Smartphone photos and videos help us to settle claims more quickly and reduce fraud.

Notes:
1. Association of British Insurers 2013 Fraud Benchmarking Data, motor savings
2. Percentage of in-scope claims where offered and accepted, six months to 31 December 2014

# Costs

## We reduced our cost base by 5.6% in 2014.

We aim to improve efficiency throughout the business to reduce costs and enable faster decision making.

We recognise the need to keep costs down, whatever the market conditions. We are updating our IT infrastructure and investing in new technology, which aims to improve efficiency, offer more flexibility and enable us to enhance our customers' experience.

### Progress in 2014

During the year, we cut costs by 5.6% and beat our target to reduce total costs[2] to approximately £1,000 million. We have achieved this by rigorously controlling discretionary costs during the year, reducing staff costs through a more efficient operating model, and lowering marketing spend.

We have progressed substantially in migrating IT applications from RBS Group infrastructure and expect to complete this in 2015. As part of this programme, we rolled out new desktop and voice infrastructure. We expect this to lead to future operational efficiencies.

£974m

**Total cost base**

We have beaten our goal of reducing costs to approximately £1,000 million, read more on page 43.

23.6%

**Expense ratio[1]**

2013: 23.7%

## Our cost performance

£58m

Reduction in cost base following a focus on cost control and operating efficiency[2], read more on page 43.

Notes:
1. The ratio is a measure of operating expenses compared to net earned premium generated for ongoing operations.
2. Total cost base for the year ended 31 December 2014 in comparison to the previous year, read more on page 43.

# Commercial

## We delivered a combined operating ratio below 100%.

Our Commercial business focuses on targeting the growing number of small and medium-sized enterprises. The business is well positioned to benefit as these customers move towards direct and e-trading distribution channels.

As the characteristics of our personal and commercial lines increasingly converge, we aim to leverage skills across these divisions, particularly in technical pricing, claims management, telematics and flood mapping.

### Progress in 2014

We continued improving the Commercial division's profitability, achieving a COR of 98.8%, beating the target ratio of less than 100%. We achieved this through a combination of factors, including a continued focus on disciplined underwriting and cost control.

Our award-winning eTrade platform continued gaining traction as we continuously improved our products and proposition. At the same time, we enhanced the Direct Line for Business customer websites with new digital functionality.

We extended PCW distribution to the van business through Churchill, and launched a new telematics offering.

**28,000**

Growth in in-force policies

## Our Commercial performance

**98.8%**

Commercial COR

We achieved this ratio through disciplined underwriting and tight cost control

**11.5%**

Gross written premium increase in Direct Line for Business landlord insurance product[1]

**5,100**

Landlord app smartphone downloads

Note:
1. Gross written premium for the year ended 31 December 2014 in comparison to the previous year.

# **Rearticulating** our strategy

## Making insurance much easier and better value for our customers.

Our strategy supports our aspiration to be the leading personal and small business general insurer in the UK.

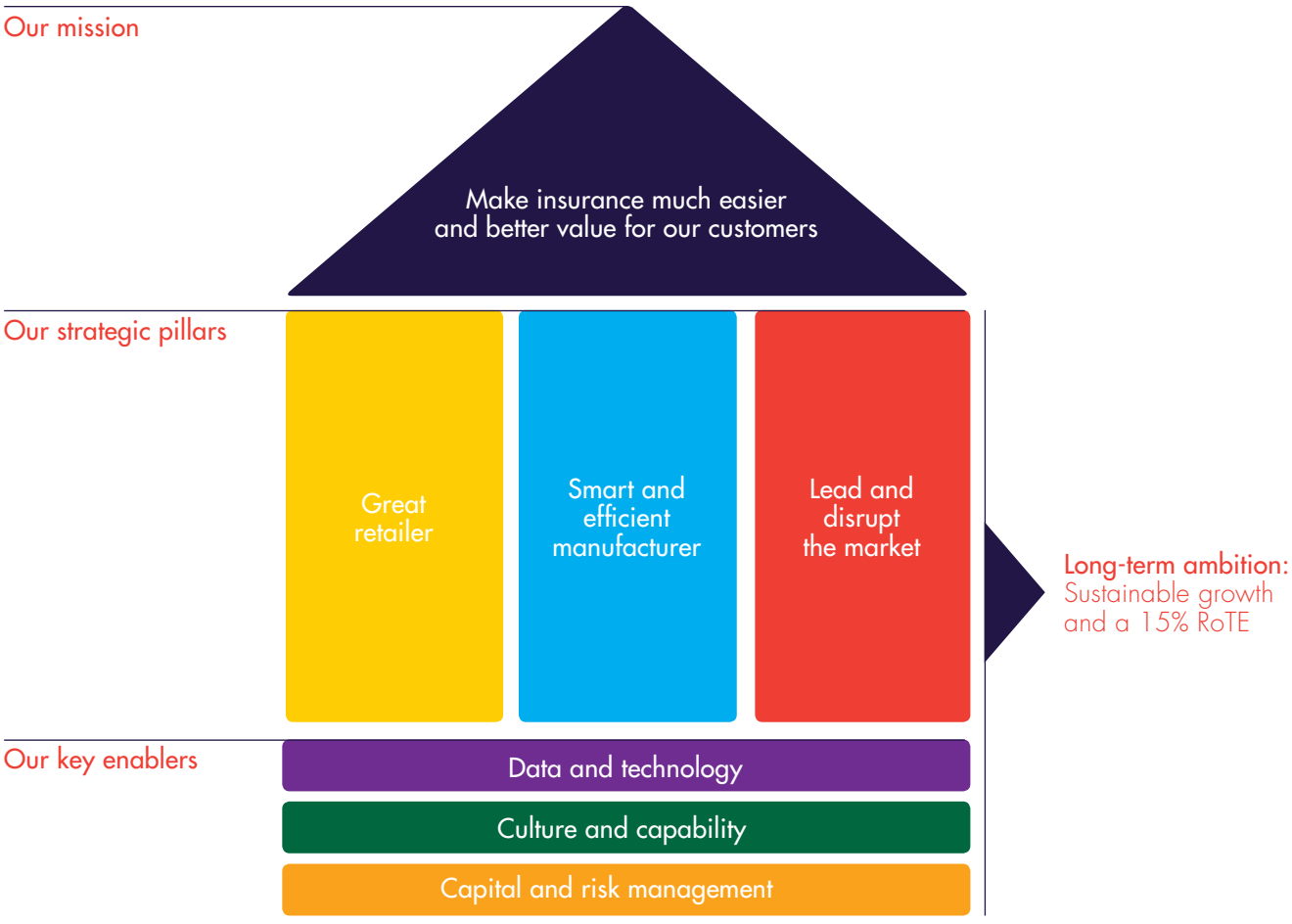
During 2014, we reviewed the components of our strategy to ensure that our business is continuing to evolve and address the constantly changing environment in which we operate.

The review reaffirmed that the capabilities underpinning the existing strategic priorities of distribution, pricing, claims, costs and Commercial remain profoundly important.

Over the last five years, the focus on these priorities has step-changed our performance and competitiveness and further investment in these areas continues to offers significant opportunity for us.

To facilitate future delivery, we have rearticulated our strategy around a simple mission: to make insurance much easier and better value for our customers.

We believe this strategy, when delivered, should allow us to grow sustainably at the same time as targeting a 15% return on tangible equity. Our discipline around future growth has not changed and we will remain focused on maximising value.



## Our strategic pillars

Our three strategic pillars demonstrate our approach to the changing needs of consumers and the wider market.

| Our strategic pillars | Our objectives |
|---|---|
| **Great retailer** | |
| Compelling brands, propositions and customer experience to meet diverse, long-term customer needs | • Further differentiate our brands including refresh of Churchill<br>• Launch customer experience programmes to increase Net Promoter Score, reduce frictional costs and reduce complaints<br>• Improve trading capability to maximise sales, cross-sales and retention while optimising margin |
| **Smart and efficient manufacturer** | |
| Efficiency and flexibility to deliver better claims and customer service at lower cost | • Continue to build technical pricing excellence<br>• Beat market claims inflation via further claims programmes<br>• Reduce level of overall costs by improving efficiency |
| **Lead and disrupt the market** | |
| Maximise existing growth opportunities while creating and driving future areas of value | • Continue to grow Green Flag<br>• Capitalise on market trends towards Direct Line for Business and eTrade to grow Commercial<br>• Double number of telematics policies in-force |

## Our key enablers

Our strategic review also reaffirmed the key building blocks required to deliver our strategic priorities. These cover data and technology, culture and capability and capital and risk management. These are the building blocks of a successful insurer and allow us to develop products for the future and continue to evolve our propositions to meet changing customer needs.

| Our key enablers | Our objectives |
|---|---|
| **Data and technology** | |
| Harness the power of technology and scale of our data | • Complete migration of IT infrastructure<br>• Continue to implement the next generation of customer systems, including policy system<br>• Update Motor pricing engine |
| **Culture and capability** | |
| Unlock and accelerate our people potential | • Investing in developing our employees' skills to capitalise on new systems<br>• Build superior people engagement via focus on leadership and people management |
| **Capital and risk management** | |
| Sound foundation of capital and risk management | • Be ready for Solvency II implementation on 1 January 2016 and submit internal model for approval |

Customers can send photos
via their smartphones for
home claims assessment

# **Improving** our customer support

We can get Direct Line customers back on the road within seven days following a motor accident

Whether it's our new Direct Line marketing campaign or the improvements we have made to our customer propositions, it is our people that have been at the heart of our success. The dedication to excellent customer service flows throughout our business and remains a key focus for us.

We have introduced new video technology tools to enable customers to reduce the amount of time it takes to settle lower value and less complex home claims. Customers are now using new technology which allows them to upload photos and videos to an online digital cloud.

## 9 out of 10

customers stated they would recommend Group brands[1]

## 94%

of customers stated their web chat experience was good or great[2]

Notes:

1. Includes Direct Line, Churchill and Privilege customers with motor or home products. 86% scoring 7 to 10 for the year ending December 2014, based on a total sample size of approximately 63,000 answers © TheLeadershipFactor 2015
2. Includes the Group's own brands: Direct Line, Churchill and Privilege for motor and home products, nine months ending 31 December 2014, based on monthly survey volumes of approximately 4,200 customers

# Measuring our performance

## We have defined eight key performance indicators that allow us to assess our performance against our strategic priorities. These are supported by further performance indicators monitored by management.

Read more about our performance rewards on page 71

### Return on tangible equity[1]
Ongoing and International (%)

16.8%

13.4% pro forma in 2012

**Definition**

The return generated on the capital that shareholders have in the business. This is calculated by dividing adjusted earnings by average tangible equity.

**Aim**

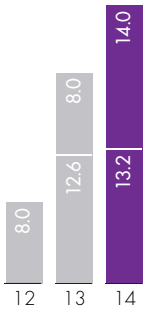
Our target is to achieve a 15% RoTE. We achieved this in 2014.

**Link to Directors' remuneration**

We base long-term incentive plan (**"LTIP"**) awards partly on RoTE over a three-year performance period.

### Dividend per share[2]
Total Group (pence)

27.2p




12.0 pence pro forma full year dividend for 2012

**Definition**

The amount of cash paid to shareholders from the Group's profit.

**Aim**

We have a progressive dividend policy and aim to grow the dividend in real terms each year. Additionally, we look to return surplus capital to shareholders when appropriate. For 2014, we paid or declared special interim dividends totalling 14.0 pence per share.

**Link to Directors' remuneration**

LTIP awards are partly based on relative TSR performance, which includes dividends. Directors also receive dividends on their beneficial shareholdings and accrue these on unvested LTIP awards.

### Combined operating ratio[3]
Ongoing operations (%)

95.0%

**Definition**

A measure of financial year underwriting profitability calculated by the sum of claims, commissions and expenses divided by net earned premium. This excludes instalment and other operating income, and investment return. A COR of less than 100% indicates profitable underwriting.

**Aim**

We aim to make an underwriting profit. In 2014, we set and achieved the target range of between 95% to 97% for the Group, this assumed a normal level of claims from weather events.

**Link to Directors' remuneration**

We base part of the Annual Incentive Plan (**"AIP"**) awards on ongoing operating profit. COR is linked closely to this.

### Total cost base[4]
Ongoing and International (£m)

£973.9m

**Definition**

The cost of doing business, including paying our people, marketing expenses and expenditure on infrastructure and IT. This includes the costs we incur in handling claims, but excludes any commissions we pay to brokers or partners, and restructuring and other one-off costs.

**Aim**

We aim to operate an efficient and effective organisation. We targeted and achieved a total cost base for 2014 of approximately £1,000 million.

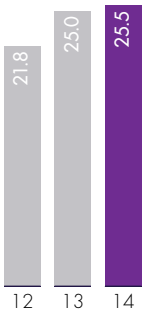
**Link to Directors' remuneration**

AIP awards in relation to 2014 include a weighting relating to cost targets.

Notes:
1. Includes discontinued operations, see note 1 on page 4
2. See note 1 on page 5
3. Excludes discontinued operations, see notes 2 and 3 on page 4
4. Includes discontinued operations, see note 4 on page 4 and read more on page 43

## Adjusted earnings per share – diluted[1] – ongoing and International (pence)

25.5p



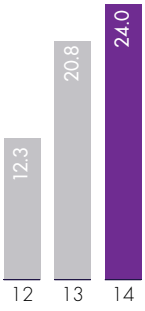

### Definition
We adjust earnings for restructuring and other one-off costs, and the result of our Run-off segment. These adjusted earnings, which reflect ongoing operations and the International division, are divided by the weighted average number of shares in issue, adjusted for dilutive potential Ordinary Shares.

### Aim
Given the cyclical nature of the insurance industry, we have not set a target for adjusted earnings per share. Growing earnings per share is considered one indicator of a healthy business.

### Link to Directors' remuneration
Growth in adjusted earnings per share is a key driver of share price performance and therefore contributes to TSR which the LTIP pay-out ratio is partly based on.

## Basic earnings per share[2] (pence)

24.0p



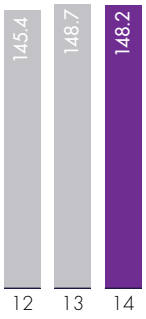

### Definition
This is calculated by dividing the earnings attributable to the owners of the Company by the weighted average number of Ordinary Shares in issue.

### Aim
Similar to adjusted earnings per share, we have not set a target. However, growing earnings per share is considered an indicator of a healthy business.

### Link to Directors' remuneration
This KPI replaces investment income yield as it links more directly to remuneration and reflects the Run-off segment and restructuring and other one-off costs. The AIP awards have a weighting to these other financial measures.

## Risk-based capital coverage[3]
Total Group (%)

148.2%




### Definition
A measure to show the level of capital held compared to the level that is required, taking into account the risks the Group faces.

### Aim
We target risk-based capital coverage between 125% and 150% to remain within our risk appetite. We also aim to maintain a rating in the 'A' range from our credit rating agencies. Both of these aims were satisfied in 2014.

### Link to Directors' remuneration
Risk management within risk appetite, which includes an assessment of capital strength, acts as a gateway for the AIP awards.

## Complaints
Principal UK underwriter[4] (%)

0.35%

### Definition
The number of complaints received during the year as a proportion of the average number of in-force policies.

### Aim
This measure indicates the level of customer service we provide. We aim to improve this over time.

### Link to Directors' remuneration
The AIP awards include a weighting to a balance of customer metrics.

Notes:
1. Includes discontinued operations, see note 3 on page 5
2. For 2014 and 2013, basic earnings per share is presented for continuing operations and excludes discontinued operations. 2012 is for total Group.
3. Adjusted for the interim dividend announced in lieu of a final dividend and the second special interim dividend.
4. For the Group's principal UK underwriter, U K Insurance Limited; it excludes discontinued operations.

# Managing risk

**We have a robust and integrated risk management framework. This framework sets out and enables the monitoring of responsibilities and accountabilities for risk management and internal control for the whole business.**

"Our risk and compliance strategy is integral to everything we do within our business."

**José Vazquez,** Chief Risk Officer

The Chief Risk Officer is a member of the Executive Committee and reports to the Chief Executive Officer. He also has access to the Chair of the Board Risk Committee and the Chairman of the Board and he also has a right of access to the Audit Committee, assuring the Risk function's independence. The Chief Risk Officer chairs the Risk Management Committee, which oversees the effective management of risk across the Group.

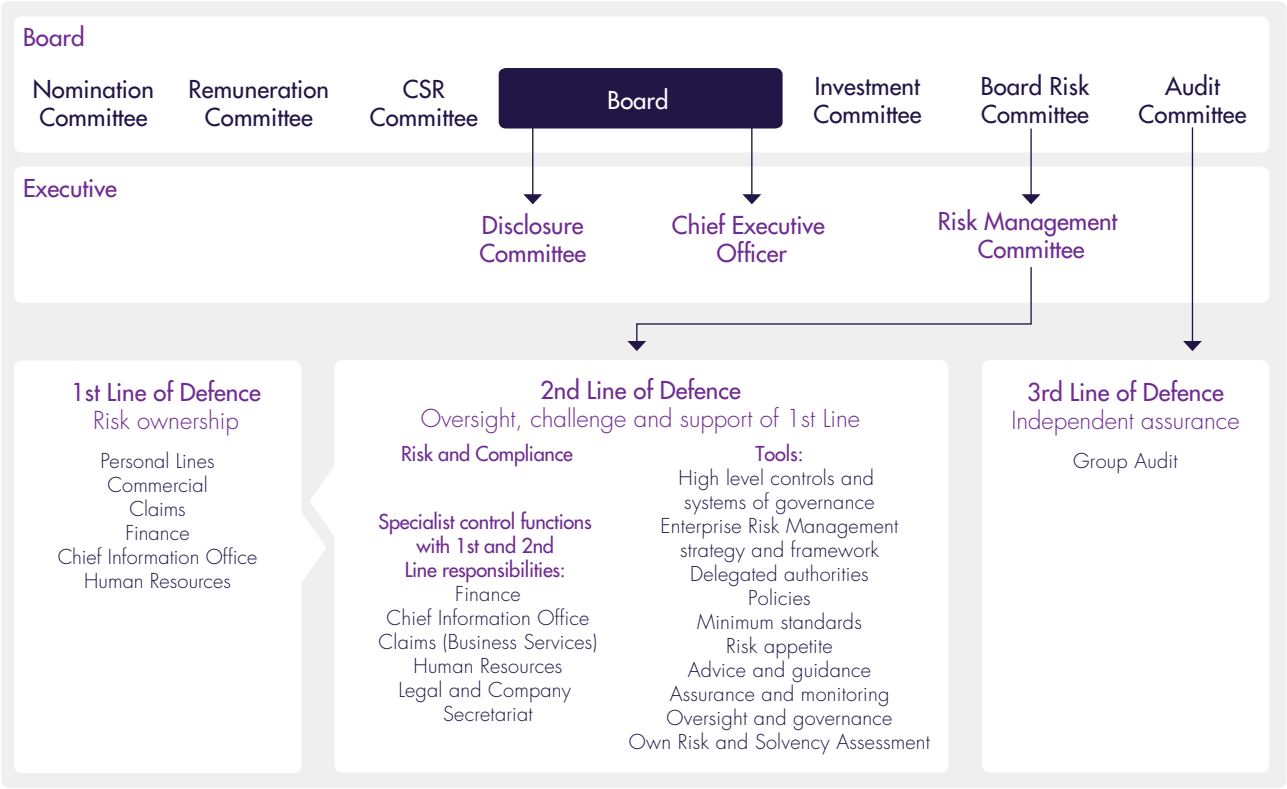
## Our risk governance structure

The Board sets and monitors adherence to the risk strategy, risk appetite and risk framework. The Board has established a risk management model that separates the business's risk management responsibilities into three lines of defence as shown in the diagram below.

The 1st Line of Defence is responsible for ownership and management of the risks to the achievement of business objectives on a day-to-day basis.

The 2nd Line of Defence is responsible for the provision of proportionate oversight of risks, issues, events and incidents.

Group Audit delivers the 3rd Line of Defence through the provision to the Board of an independent view of the effectiveness of risk management and controls.



## Managing risk in line with Group strategy

Management, and ultimately the Board, are responsible for developing our Group strategy. Our strategic planning process aims to ensure we have developed clear objectives and targets and identified the actions needed to deliver them. These must be consistent with our overall objective of a 15% RoTE and delivered in line with our risk appetite. For more information on our strategy, see page 16.

Delivering a strategic plan will, by its very nature, result in taking risks. Identification of these risks is a key aspect of the strategic planning process, placing importance on the link between strategy and its impact on capital. We place Enterprise-wide Risk Management (**"ERM"**) at the very heart of our approach.

## Risk strategy and appetite

Direct Line Group's risk appetite statements articulate the level of risk the Group is prepared to accept to achieve its business objectives. To monitor whether the Group remains within our risk appetite, the statements are aligned to key business metrics and used to drive risk-aware decision-making by key business stakeholders.

These metrics form key risk indicators (**"KRIs"**), which are both qualitative and quantitative, and forward and backward looking. We review our risk appetite statements and KRIs annually, using outputs from the Internal Economic Capital Model and taking our business plan into account. For information on our allocation of capital by risk type, see page 48.

The diagram below outlines the Group's risk objectives and risk appetite statements.

## Our ERM framework

ERM is the process of organising and controlling the activities of the whole Group so as to ensure we remain within risk appetite. To enable ERM, we have developed a framework comprising a number of components which are fundamental to good risk management. These are shown in the diagram overleaf.

A central component of the ERM framework is our policy framework, which includes policies and minimum standards. These inform the business how it needs to conduct its activities to remain within risk appetite.

We also employ a number of risk tools to manage and monitor our risks. We test and report on the output of these tools both internally and externally.

We have an annual review programme to ensure our ERM and policies remain fit for purpose.

## Our strategy

| Risk objective | Risk appetite statement |
|---|---|
| **Overarching risk objective** | The Group recognises that its long term sustainability is dependent on having sufficient economic capital to meet our liabilities as they fall due, thus protecting our reputation and the integrity of our relationship with our policyholders and other stakeholders.<br>As part of this, our appetite is for general insurance risk, focusing on personal lines retail and SME insurance in the United Kingdom. We have appetite for non-insurance risks, as appropriate, to enable and assist us to undertake our primary activity of insurance. |
| **Maintain capital adequacy** | We seek to maintain sufficient economic capital consistent with our strategic aim of achieving a standalone credit rating in the 'A' range. We also seek to hold capital resources in the range of 125%-150% of risk based capital. |
| **Stable and efficient access to funding and liquidity** | We aim to meet both planned and unexpected cash outflow requirements, including those requirements that arise following a 1 in 200-year insurance, market or credit risk event. |
| **Maintain stakeholder confidence** | We have no appetite for material risks resulting in reputational damage, regulatory or legal censure, fines or prosecutions and other types of non-budgeted operational risk losses associated with the Group's conduct and activities.<br>The Group will maintain a robust and proportionate internal control environment. |

## Our risk culture

Our ERM strategy and framework sets out the mechanisms to manage risk aligned to our Group strategy. The Board approves our Group strategy, risk appetite and policy framework. The Board Risk Committee approves our ERM strategy and framework.

Risk culture involves applying the ERM strategy and framework's principles, processes and tools in our day-to-day behaviour. A good risk culture is one where risk management is a significant part of the way we work.

Our risk culture focuses on the key areas of strategy, employees, promoting good governance, communication, systems and reporting.

Our culture and ERM strategy and framework are mutually supportive. We believe that the promotion of a good risk culture across the Group and by all of our employees helps embed risk management within our business.

## Solvency II

Solvency II is the European insurance industry's new framework for the capital adequacy regime. It establishes a revised set of European Union-wide capital requirements and risk management standards, which aim to better protect policyholders. Solvency II is scheduled for implementation on 1 January 2016. The Group continues to make progress to ensure we meet all requirements in line with developing best practice.

We are embedding the Group's ERM framework in respect of Solvency II, including the use of forward looking risk assessment based on the Own Risk and Solvency Assessment (**"ORSA"**) principles. The Group continues to use and enhance its Internal Economic Capital Model, which is used to support our business and strategic decisions from a risk-based capital perspective.

## Emerging risks

The Group's definition of emerging risk is consistent with the Solvency II definition in that it focuses on newly developing or changing risks that are difficult to quantify but may have a major or material impact on the business. The Group has further defined emerging risks as fulfilling some of the following criteria:

- They are risks which are external to the Group
- They are new or changing risks
- They are subject to a high degree of uncertainty
- There is scope for mitigation either now or in the future

We record emerging risks within an Emerging Risk Register which aligns to the risk taxonomy underpinning the Material Risk Register. These emerging risks link into the ORSA reporting cycle. They are also part of the risk-reporting framework to the Executive Risk Management Committee and the Board Risk Committee for review, challenge and approval, and feed into the Board's strategic planning process.

During 2014, we enhanced our emerging risks processes. Supported by stress and scenario testing, the processes aim to:

- Achieve early recognition of risks
- Reduce the uncertainty and volatility of business results
- Take a proactive approach to managing emerging risks
- Identify, manage and monitor a broader range of risks
- Mitigate the potential impact on our profit and loss account and balance sheet.

On 1 April 2014, the FCA took over the regulation of Consumer Credit from the Office of Fair Trading. Firms within the Group currently have interim permission for consumer credit activities and will be applying for full permissions during 2015.

## Main emerging risks:

- 'Big data', including cybercrime, data regulation and information security
- Climate change
- New car technology, for example, driverless cars
- Major new market entrants
- New insurance distribution models
- Changing approach to conduct regulation
- Change in UK legislative environment
- Pandemics

Note:
1. Material Risk Assessment

## Principal risks and uncertainties

Risks are always present in our business. It is important to ensure that we identify, measure, monitor and report these risks throughout the business on an ongoing basis. We also monitor changes in these risks over time. We believe these risks are broadly unchanged over the last year.

| Principal risks | Owner | Management and mitigation examples |
|---|---|---|
| **Insurance risk: Underwriting and pricing**<br>We face the risk that future claims and expenses are not as predicted. This includes catastrophe risks arising from losses due to unpredictable natural and man-made events. See page 119. | Managing Directors of Personal Lines and Commercial | • We have set underwriting guidelines for all business transacted<br>• We refine pricing through analysis of comprehensive data<br>• We purchase Catastrophe and Motor excess of loss reinsurance, limiting our exposure to large losses<br>• We invest in enhanced external data to analyse and mitigate exposures |
| **Insurance risk: Reserving**<br>We face the risk that the run-off of reserves is not as predicted, driven by our large Motor portfolio and periodic payment orders ("**PPOs**") because of their long-term nature. See page 118. | Chief Financial Officer | • We estimate the technical reserves using a range of actuarial and statistical techniques<br>• We ensure that management's best estimate of reserves is not less than the actuarial best estimate<br>• Our reserves estimates are subject to third-party reviews |
| **Strategic risk**<br>The risk of direct or indirect adverse impact on the earnings, capital, or value of the business as a result of the strategies not being optimally chosen, implemented or adapted to changing conditions. | Chief Executive Officer | • We have agreed strategic targets which are monitored and managed<br>• We run an annual strategy process which considers Group performance, competitor positioning and strategic opportunities<br>• We identify and manage emerging risks using an established governance process and forums |
| **Operational risk**<br>We face the risk of losses resulting from inadequate or failed internal processes, people and systems, or from external events. | Specific members of the Executive | • We have strong operational processes and systems, including fraudulent claims detection systems<br>• We maintain a robust internal control environment, see page 60<br>• We have developed a bespoke risk capture, management and reporting system |
| **Market risk**<br>We are exposed to fluctuations in the value of, or the income from, our investment portfolio. See page 121. | Chief Financial Officer | • We manage and control our investment portfolio through:<br>– investment strategy and guidelines approved by the Board; and<br>– diversity in the types of assets held<br>• We use risk-reduction techniques such as hedging foreign currency exposures with forwards, and hedging US Dollar interest rates with swaps |
| **Counterparty risk**<br>We partner with many suppliers, in particular for reinsurance. The failure of any of these partners could result in a financial loss. See page 124. | Chief Financial Officer | • We set credit limits for each counterparty<br>• We only purchase reinsurance from reinsurers with a minimum 'A-' rating<br>• We actively monitor broker credit exposures |
| **Regulatory risk**<br>Risk arises from changes in law and regulations (including changes of interpretation) not being identified, interpreted or adopted correctly, including Solvency II. | Chief Risk Officer | • We have a constructive and open relationship with our regulators<br>• We use specific risk management tools and resources, such as our upstream risk team, to help manage exposure to regulatory risk<br>• We exercise risk-based monitoring to ensure we use our resources to the greatest impact |
| **Conduct risk**<br>Failure to treat our customers appropriately or failure by our people to behave with integrity. | Chief Executive Officer | • Our organisational culture prioritises a consistent approach to customers. Our customers' interests are at the heart of how we operate<br>• We have developed a robust customer conduct risk management framework to minimise our exposure to conduct risk, see page 65 |
| **Brand and reputational risk**<br>We depend on the strength of our brands and our reputation with customers and distributors. | Specific members of the Executive | • We regularly review our brand and reputational risk through our governance framework<br>• We undertake substantial marketing activities to protect and build our brands, and measure their effectiveness regularly |

# Establishing solid foundations

We aspire to be the leading personal and small business general insurer in the UK. We know that we can succeed only if we earn the trust of our stakeholders. This means we must consider the impact of each and every decision we make on society, as well as thinking about what it means for our business.

## Approach and priorities

CSR is about how we make our money. We believe being recognised as a trusted, responsible company can boost our reputation, engage our people and improve stakeholder relations.

Three key principles drive our approach:

- We acknowledge that we have a responsibility to wider society, including the community and the environment
- In our business of providing insurance and other services, we seek to operate in a way that demonstrates this wider responsibility
- This is a collective and individual responsibility

These principles are at the heart of our CSR Charter. The Charter defines our commitment to CSR and links to our values, code of conduct and policy framework, which guide our behaviour. The Charter is published on the Group's website.

Our approach is overseen by the CSR Committee, see page 66

Our CSR strategy

The CSR Advisory Group, formed of senior managers and chaired by a member of the Executive Committee, ensures CSR is embedded across our business. The Sustainability team supports the Advisory Group and manages CSR activity on a daily basis.

Four key strands – sustainable business practices, employee experience, community, and energy and environment – provided the framework for our CSR activity in 2014 and form the basis of this report. External feedback and our own benchmarking indicate that we are making good progress. Full details of our performance against last year's targets as well as our 2015 targets are set out on the Group's website.

Having established solid foundations, for 2015 we have prioritised our focus areas for each strand to sharpen our approach. As shown in the graphic, they are 'Helping to make our society safer', 'Proud to be here', 'Recognised as part of our communities' and 'Reduce, Reuse, Recycle'. A separate member of our Executive team is now responsible for each strand.

## Sustainable business practices

Our products, services and operations affect our many stakeholders.

### Working with Government

In order to ensure homeowners who are vulnerable to flooding continue to be able to receive affordable home insurance, we are working closely with Government with the aim of introducing the Flood Re programme in 2015.

The Government continued its programme of legal reforms to combat motor insurance fraud during the year. We have been actively involved in MoJ working groups to ensure a strong industry voice. Insurance fraud has a big impact on premiums so it is important for customers that we achieve the right outcome from these reforms.

We recognise that there is a general concern about lobbying and we continue to engage only in public policy debates that have an impact on our business or our stakeholders. We do not support party political interests or make political donations.

### Improving road safety

In our Motor division, we developed our telematics propositions. The technology enables us to better assess each person's driving risk. More importantly, the feedback we give drivers encourages safer and more considerate driving, which we expect will help lead to safer roads. We have aimed our telematics propositions primarily at younger drivers, who are disproportionately involved in road traffic accidents.

In September 2014, we highlighted a rarely addressed road safety issue to Government: drink-driving among women. Our report, 'Drinking Amongst British Women and its Impact on their Pedestrian and Driving Activities', found that the percentage of those convicted of drink driving who are women had nearly doubled since 1998. Consequently, the Government said it would consider how its anti-drink-driving THINK! campaigns might target a female audience.

We have a long-standing partnership with 'Brake', the road-safety charity. We have funded Brake's research into driver attitudes and behaviours and used the findings to run a series of media campaigns to raise awareness of topical road safety issues such as driving under the influence of drink or drugs, long journeys and the effects of tiredness, speeding, driving in winter conditions and the importance of proper car maintenance.

We also sponsored Brake's Parliamentarian of the Year Awards, which recognise Members of Parliament who campaign on road safety issues, and supported its primary school education programme, 'Beep Beep!'

Within our network of Accident Repair Centres we operate a fleet of 73 trucks. During 2014, we fitted all our trucks with a safety tool called 'Tracker Fleet'. This enables us to improve route planning, which reduces fuel costs and carbon emissions; monitor and avoid traffic hotspots; view truck locations to cut down on calls to drivers; and gather driving-behaviour data to raise awareness of road safety issues.

Our trucks operate mainly in urban areas with high populations. The Government has targeted these areas for investment in cycling. Not surprisingly, accidents involving cyclists and large vehicles, such as trucks, often result in serious injury. That is why we are trialling a new closed-circuit television (**"CCTV"**) system which improves visibility around trucks and warns drivers of potential hazards. If successful, we will roll out CCTV to the entire fleet in 2015.

### Suppliers

Our Ethical Code for Suppliers sets out our approach to managing CSR-related matters across our supply chain.

Last year, within our Home Repair Network, we partnered with a new supplier, 'Anyjunk'. Following a claim, Anyjunk offers a 'man in a van' waste collection service that removes and looks to recycle household waste. Anyjunk reports regularly on what it has collected and recycled. This greatly improves the transparency of our business. Anyjunk is currently recycling 85% of the waste collected from our customers.

In 2015, we are focusing on developing our supplier-management programme, promoting CSR across our strategic suppliers, and setting challenging targets to reduce our impact on the environments in which we operate.

### Living wage

We ensure all our employees, whether in our offices or our Accident Repair Centres, are paid at or above the living wage.

### Responsible investment

We look to mandate external asset managers who show they are committed to using their market leverage to support environmental, social and governance (**"ESG"**) objectives. We favour asset managers with an active, ongoing demonstrable engagement in local or global ESG initiatives and encourage them to be signatories to the UN Principles for Responsible Investment. However, we do not set ethical parameters for our asset managers regarding the issuers in which they can or cannot invest. In 2014, we approved a mandate to invest in UK infrastructure debt. We require at least 30% of this mandate, once invested fully, to be allocated to social-infrastructure assets, for example, healthcare, education and government buildings.

## Energy and environment

We aim to manage our operations in a sustainable way.

### Emissions

Group-wide greenhouse gas (**"GHG"**) emissions are shown in the chart below. You can find more details of our emissions in the Directors' report on page 96.

Energy use is a key driver of our emissions. Our Property Management team has developed an energy-saving plan. This involves seeking to optimise our buildings' heating, ventilation and air-conditioning systems, and a programme of investment in energy-efficient devices, such as lighting. Since April 2014, 100% of the Group's purchased electricity has been from renewable sources on green tariffs.

**85%**

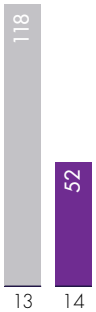
**Waste recycled from our Home Repair Network claims**

**Greenhouse gas emissions[1]** (tonnes)

↓6.2%

**Paper used[2]** (tonnes)

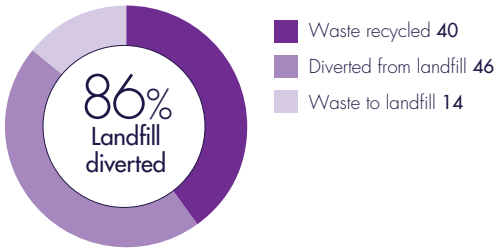
↓56%



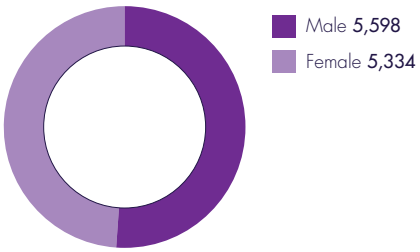

Notes:

1. Emissions for continuing operations. This excludes discontinued operations, the Group's International division. Total Group emissions including discontinued operations are 28,759 tonnes (2013: 30,624 tonnes).
2. Paper used for 2013 has been re-presented for printing and copying at our main office sites.

## Office waste
(%)




## Gender diversity of all employees




# 100%
## Electricity from renewable sources on green tariffs

### Waste
After introducing a new system to sort waste at source, we recycled an average of 40% of waste from our offices and 60% of waste from our UK Accident Repair Centres.

We diverted 86% of our waste from landfill in 2014 including recycling.

### Paper use
Through our desktop and printing transformation programme, we have replaced our old hardware with new Multi Functional Devices (**"MFDs"**). This has significantly reduced energy and paper use. The graph on the previous page shows our paper consumption. Our office paper is made from recycled material. All our waste paper is recycled.

## Employee experience
Our people strategy continued its focus on ensuring we have the right capability to deliver our strategic objectives with particular focus on leadership and people managers.

### Engagement
Our business areas focused on capability and engagement plans to help embed and build upon the transformational activity of the previous year. Our aim of involving people and encouraging a sense of ownership led to the continued development of our employee representative bodies and other participative approaches as well as key initiatives such as confirming a further free share award, see page 155, and enhancements to our Buy-as-you-Earn scheme effective in early 2015.

Employee feedback remains an important gauge. During the first half of 2014 we completed a 'pulse' survey, with our new employee opinion survey DiaLoGue taking place in November. DiaLoGue uses a significantly more robust and demanding measure of engagement that is directly linked to our strategic priorities.

On a like-for-like basis, engagement has increased overall to 76% (2013: 71%). Using the new and more challenging methodology which is aligned to our ambition to be a top employer we scored 45% which is comparable to industry norms. The survey continues to show that people have a strong understanding of our ambitions, customer focus and a commitment to playing a part in the future growth of the Group and we will continue to build from this positive base over coming years.

### Recognition
We made a key change to our recognition framework in 2014 by redesigning our Chief Executive Awards programme. This provided greater autonomy for business locations to nominate and decide who should receive an award for contributions relating to our Company values. Each location organised the event that best suited their people.

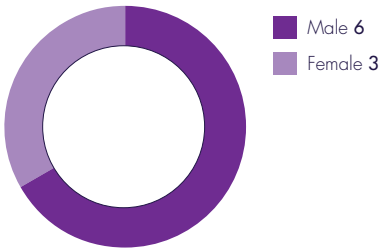
The changes proved a great success, resulting in a more tailored and personal approach, and really positive feedback. Since launch, eight ceremonies have been held with over 2,000 nominations resulting in more than 400 people being shortlisted and over 100 people being recognised for their contribution.

### Human rights and diversity
Our diversity and inclusion practices are in line with the Universal Declaration of Human Rights. We continue to work towards an environment that is based on meritocracy and inclusion, where all employees can develop to their full potential. This is irrespective of their age, beliefs, disability, ethnic or national origin, gender, gender identity, marital or civil partnership status, political opinion, race, religion or sexual orientation.

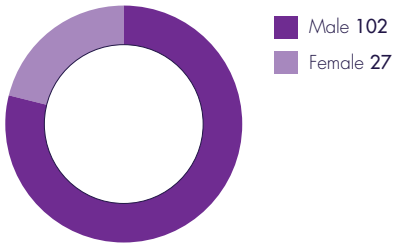
Through our Ethical Code for Suppliers, we adhere to the core International Labour Organization standards.

During 2014, our Diversity Network Alliance (**"DNA"**) continued building its visibility throughout the business by, for example, attending London Pride and giving employees the opportunity to learn about a range of diversity topics through informative articles on the company intranet. DNA also promoted an inclusive culture through a series of networking and educational events, and seminars covering unconscious bias, balancing work and other topics.

### Gender diversity of Board members




### Gender diversity of senior managers




The ratio of female-to-male employees at 31 December 2014 is shown in the charts.

## Community

We believe how our people feel about working here is linked to our wider reputation in the community. That is why we seek to align our giving with our employees' interests.

### Community and social committees

To drive engagement among our people, we operate a network of Community and Social Committees (**"CASCs"**), The CASCs, which comprise local volunteers, receive central funding and support. Within an agreed framework, they are free to create their own programme of events and activities for their site, and build relationships with local charities and voluntary organisations.

We encourage all employees to volunteer individually or as a team through our 'One Day initiative', ideally with a local organisation with which they already have a connection. For example, our Logistics team chose to support the charity, 'Carers Leeds'. The team helped the charity to reduce the costs associated with mailing out their newsletters.

According to our Employee Opinion Survey, last year 31% of staff fundraised or volunteered in Company time.

### Matched giving

We operate a well-established and generous Payroll Giving scheme that matches regular employee charitable donations up to £50 per month. In 2014, we achieved Silver in the 'Payroll Giving Quality Mark and Awards'. The Awards, administered by the Institute of Fundraising and supported by the Cabinet Office, recognise and reward businesses that are committed to Payroll Giving.

**£154,000**
**Employee donations through our Payroll Giving scheme**

**31%**
**Employees volunteering or fundraising in company time**

We also provide grants of £250 to organisations for which our employees regularly volunteer or raise funds in their own time.

In 2014, our employees donated £154,000 through our Payroll Giving scheme and we donated a further £94,000 in matched giving. We also donated £46,000 in grants.

### Strategic partnerships

In addition to our partnership with the road safety charity Brake, see page 33, we have recycled funds received from taking on apprentices through the Government's Wage Incentive Scheme and used them to help other young unemployed people through a structured programme of support delivered by the leading charity, 'Groundwork'.

SILVER AWARD 2014
PAYROLL GIVING

# Personal lines

"We continue to improve our customer experience and propositions through investing in new capabilities."

**Mike Holliday-Williams**
Managing Director of Personal Lines

## Motor

### Highlights

- Retained position as Britain's leading personal motor insurer, with a 13.1% share of in-force policies[1]
- Operating profit reduced by 14.6% due to lower levels of prior-year reserve releases and adverse large bodily injury claims volatility in 2014, partly offset by lower costs and a higher investment return
- Continued to develop customer functionality and propositions during the year, launched new tablet and smartphone-optimised websites and a self-install telematics proposition

### Performance highlights

| | 2014 | 2013 |
|---|---|---|
| In-force policies (thousands) | 3,672 | 3,762 |
| Gross written premium | £1,342.0m | £1,421.1m |
| Loss ratio | 67.0% | 65.1% |
| Commission ratio | 3.2% | 2.5% |
| Expense ratio | 26.0% | 25.6% |
| Combined operating ratio | 96.2% | 93.2% |
| Operating profit | £297.1m | £347.7m |

### Market

The UK economy continued expanding, while in the European Union area output grew modestly and domestic demand weakened. This may subdue UK growth in the future. Consumer price inflation has been lower than expected. This led to a delay in anticipated rises in base interest rates and continued the trend of low investment returns on debt securities.

The total number of cars on the road increased to 32 million supported by car manufacturing, rising approximately 4% on the previous period, as economic confidence rose. Fuel prices were broadly stable for most of the year although did fall late in the year, while total distance travelled increased.

The motor insurance market was highly competitive with further premium deflation at the start of the year. As the year progressed premium rates flattened. PCWs continued to take a central role in the market as customers shopped around. The CMA introduced a ban on wide 'most favoured nation' clauses, which aims to increase competition further.

### Performance

We continued enhancing our customer functionality through new tablet and smartphone-optimised websites. We also improved our customer propositions, including rolling out a self-install telematics proposition.

We continued making choices designed to optimise value and prioritise underwriting profit over volume growth. Furthermore, these results reflected previous actions to reduce risk and manage claims costs. These have helped us manage the business successfully through a dynamic and evolving regulatory landscape and competitive marketplace.

**Effect on premium income of changes in price and risk mix[2]**

| | Q4 2014 | Q3 2014 | Q2 2014 | Q1 2014 |
|---|---|---|---|---|
| Change in price | 1.7% | – | (2.3%) | (5.1%) |
| Change in risk mix | (1.0%) | (2.6%) | (2.3%) | (1.0%) |

Gross written premium of £1,342.0 million reduced by 5.6% and in-force policies reduced by 2.4%, compared with 2013. Overall, prices increased marginally in the fourth quarter of 2014 compared with the same period last year, while risk mix reduced by 1.0%. Our prices were more competitive in a stable market, and the benefits from improvements in pricing capability continued.

Underwriting profit reduced by 49.2% to £49.8 million. This was mainly due to lower, albeit still significant, prior-year reserve releases and adverse volatility in large bodily injury claims in 2014. These factors increased the loss ratio by 1.9 percentage points. The expense ratio deteriorated by 0.4 percentage points as benefits from the Group's cost saving plans were offset by a reduction in net earned premium. The commission ratio deteriorated by 0.7 percentage points as a result of an increase in profit commission payments due to partners.

Overall operating profit was £297.1 million, a reduction of 14.6% compared with 2013, as lower underwriting profit and lower other income was offset by better investment returns.

### Outlook

A number of headwinds are facing the motor market as we enter 2015, in particular the return to a more normal long-term claims inflation versus evidence in the early part of the year of continued market competition. Against these headwinds, we end the year conservatively reserved, from which we continue to expect material reserve releases assuming current claims trends continue, and a programme of initiatives to deliver further capability improvements.

Notes:

1. See note 1 on page 7
2. Risk mix reflects the expected level of claims from the portfolio. It measures the estimated quarterly movement to the same quarter in the previous year based on risk models used in that period and is revised when risk models are updated.

# Home

## Highlights

- Retained position as one of Britain's leading home insurers with a 16.7% share of in-force policies[1]
- Own brand customer retention improved on last year as we continued investing in pricing programmes
- Delivered claims customer experience improvements using smartphone technology for Home claims assessment
- Operating profit increased by 7.3% due to an improved attritional loss ratio performance and lower costs, partially offset by higher profit commissions due to partners.
- COR improved by 1.1 percentage points to 92.7%

## Performance highlights

| | 2014 | 2013 |
|---|---|---|
| In-force policies (thousands) | 3,526 | 3,719 |
| Gross written premium | £898.6m | £943.1m |
| Loss ratio | 50.8% | 53.9% |
| Commission ratio | 21.7% | 19.6% |
| Expense ratio | 20.2% | 20.3% |
| Combined operating ratio | 92.7% | 93.8% |
| Operating profit | £113.9m | £106.2m |

## Market

The economic downturn strongly affected new home building. However, this has now recovered and increased by 16% on the previous period. This led to the overall net supply of new house builds increasing by 10% on the previous year.

Competition in the home insurance market increased and the market trend of new business premium deflation continued[2]. A number of trends contributed to the competition including growth in the use of PCWs, increased competitiveness from insurers via panels, in some cases supported by reinsurers, and motor insurance providers focusing on home insurance products. Changes in the regulatory environment continued to affect banks and building societies, and their branch sales of insurance were subdued.

The insurance industry continued working with the government and the Association of British Insurers on the set up of Flood Re and the associated levies, costs and processes. This aims to make home insurance more affordable for customers in the highest-risk flood areas.

## Performance

We delivered another good result in 2014, as we continued investing in pricing programmes and claims transformation allowing us to compete in an increasingly competitive market. Own brands customer retention also improved on the previous year.

Gross written premium of £898.6 million reduced by 4.7% and in-force policies fell by 5.2% since last year. This was mainly due to lower new business volumes impacted by competitive market conditions, partially offset by an improvement in customer retention.

Underwriting profit increased by 13.0% to £63.5 million. The loss ratio improved by 3.1 percentage points reflecting a focus on enhancing risk selection and continued prior-year reserve releases. Claims costs from major weather events of £63 million were broadly in line with 2013 (£69 million). Adjusting for claims from major weather events the current-year attritional loss ratio of 49.2% was 1.9 percentage points lower than 2013.

The commission ratio deteriorated by 2.1 percentage points due to a one-off adjustment to historic profit-share payments and increased profit-share payments as a result of higher profitability in 2014. The expense ratio improved by 0.1 of a percentage point as lower costs from improvements across the Group were partly offset by a reduction in net earned premium. Overall, operating profit improved by 7.3%.

## Outlook

Following significant new business premium deflation in 2014, the home market has stabilised in the early part of 2015, but remains an area of uncertainty. For own brands, we will continue to use the benefits from our pricing and claims initiatives to enhance our competitive position, while working with our partners to optimise the value of their current market positions. One of our largest partners, Nationwide, is currently reviewing its home insurance provider as our contract approaches renewal. We will continue to work with key stakeholders to facilitate a successful implementation of Flood Re.

Notes:

1. See note 1 on page 7
2. Based on online independent research by Consumer Intelligence in 2014; data obtained from 2,100 risk profiles from 34 companies.

# Rescue and other personal lines

## Highlights

- Rescue in-force policies grew by 3.3% in the year, driven by Green Flag's new marketing campaigns and propositions
- Other personal lines in-force policies reduced by 7.0%, due to a reduction in Travel policies connected to the sale of packaged bank accounts
- Gross written premium decreased by 3.0% to £371.8 million, driven by the sale of Direct Line Life Insurance Company Limited (the "**Life business**") in November 2013
- Adjusting for the Life business, underlying gross written premium rose 4.5%, primarily due to Green Flag and pricing initiatives
- Operating profit increased by 3.2%, due to Green Flag's strong underlying performance and higher prior-year reserve releases in Travel than in 2013

## Performance highlights

| | 2014 | 2013 |
|---|---|---|
| In-force policies (thousands) | | |
| Rescue | **4,075** | 3,944 |
| Pet | **221** | 246 |
| Travel | **4,061** | 4,295 |
| Other | **235** | 316 |
| Gross written premium | **£371.8m** | £383.4m |
| Loss ratio | **57.4%** | 60.1% |
| Commission ratio | **9.4%** | 7.5% |
| Expense ratio | **25.2%** | 24.8% |
| Combined operating ratio | **92.0%** | 92.4% |
| Operating profit | **£48.0m** | £46.5m |

## Market

The wider economic trends are similar to those detailed in the Motor and Home market reviews on pages 36 to 37.

The roadside assistance market, in which there are three key providers including Green Flag, is expected to grow broadly in line with the number of cars on the road. Roadside assistance products are bought direct from providers; linked to the sale of motor insurance; through PCWs; and provided as a component of a packaged bank account through partners. Customers place a high level of importance on service.

The number of pets in the UK remained stable over the last year, as has the level of customer take-up of insurance cover[1]. However, higher veterinary medical costs led to increased claims costs. Providers mitigated these costs by increasing average premiums. For insurance providers, veterinary practices also remained a key distribution route to customers.

High volumes and penetration rates continued to characterise the travel insurance market. The uptake of insurance mirrored the UK population taking an increasing number of trips abroad, as the economy improved. Medical claims continued to represent the largest component of claims spend. However, the strength of the Pound Sterling partially offset overseas medical inflationary pressures on claims costs in 2014. Customers continued to purchase cover through PCWs and as part of packaged bank accounts. Purchases through travel agents have reduced over time.

## Performance

A new marketing campaign and propositions, including our misfuelling proposition, successfully continued to differentiate Green Flag from its peers. Our Travel and Pet product lines delivered positive results, in Travel this resulted from price increases. The results included higher prior-year reserve releases.

Gross written premium of £371.8 million decreased by 3.0% from £383.4 million in 2013. This was due to the sale of the Life business in November 2013. Adjusting for the Life business, underlying gross written premium increased by 4.5%. This reflected increased direct sales of Green Flag products. Gross written premium for Travel products increased 8.9%, resulting from price increases, which offset a reduction in in-force policies. Pet gross written premium remained stable.

Underwriting profit increased by £1.7 million on 2013 while the loss ratio improved by 2.7 percentage points to 57.4% due to an improved underlying performance benefitting from price increases, reduction of claims from weather and higher prior-year reserve releases. The expense ratio deteriorated marginally by 0.4 percentage points. Overall, operating profit increased 3.2% to £48.0 million. Of the total operating profit, Rescue delivered £41.5 million, a £3.3 million improvement on the previous year.

## Outlook

Rescue and other personal lines continues to represent an opportunity to meet customers' broader insurance needs and create additional value for the Group. Green Flag represents a strong offering in the Rescue market and we will look to build on its recent market share gains. During 2015, we also aim to review our Pet operating models to enhance our service while updating our customer proposition.

Note:

1. Source: Association of British Insurers

# Commercial

"By focusing on the SME sector, maintaining our underwriting discipline and driving improvements in efficiencies, we exceeded our target and delivered a COR of 98.8%."

**Jon Greenwood**
Managing Director of Commercial

## Highlights

- Achieved the sub-100% COR target set for 2014, delivering a COR of 98.8%
- In-force policies continued to increase with 4.8% growth in 2014. This was driven by Landlord and Tradesman products, and partially offset by a reduction in Van
- Gross written premium increased by 2.6% to £487.0 million, with growth in eTrade and Direct Line for Business, partially offset by Van
- Continued improvement of the eTrade products and propositions, and launched a Churchill Van product
- Operating profit of £47.0 million represented a substantial increase on 2013, due to a continued focus on disciplined underwriting and cost control

## Performance highlights

| | 2014 | 2013 |
|---|---|---|
| In-force policies (thousands) | 611 | 583 |
| Gross written premium | £487.0m | £474.5m |
| Loss ratio | 57.1% | 62.3% |
| Commission ratio | 19.7% | 21.2% |
| Expense ratio | 22.0% | 23.3% |
| Combined operating ratio | 98.8% | 106.8% |
| Operating profit | £47.0m | £9.5m |

## Market

The UK economy, business investment and productivity continued expanding. The number of new companies registered and people in employment has risen.

Businesses are increasingly purchasing policies online and through banks. The purchase of commercial van insurance direct from insurance providers remains the main channel for this product.

Levels of buy-to-let lending rose on last year. Tighter lending criteria were introduced in April 2014 for home owner-occupier mortgages. These do not apply to buy-to-let mortgages and in fact, the proportion of privately rented residential properties is more than one in six – the highest level since the 1970s.

## Performance

In-force policies continued to increase with 4.8% growth in 2014. Growth was particularly in the strategically important Direct Line for Business and eTrade segments, with higher in-force policies from Landlord and Tradesman products. We continued to improve the functionality of our eTrade product suite and launched a Churchill Van product, which focuses on growing distribution through PCWs. We also piloted telematics propositions with Direct Line for Business and NIG customers.

Gross written premium increased by 2.6% compared to last year, with growth in eTrade and Direct Line for Business benefiting from previous investments. The commercial van market, similar to the UK personal motor market, was highly competitive.

The COR improved to 98.8%, achieving our 2014 target. The loss ratio improved by 5.2 percentage points to 57.1%, driven by a continued focus on disciplined underwriting and the non-repeat of the above-average level of large claims experienced in 2013. This included significant prior-year reserve releases, which were broadly in line with the level of 2013. The expense ratio improved by 1.3 percentage points to 22.0%. This was due to the continued benefits from our regional restructure during the previous year and cost improvement programmes across the Group. The commission ratio improved by 1.5 percentage points to 19.7%.

Overall operating profit increased by £37.5 million to £47.0 million for the year. This was delivered principally due to a continued focus on disciplined underwriting and cost control.

## Outlook

In 2015, we aim to build on the profitable position established by the Commercial division following the achievement of its COR target in 2014. In particular, we are looking to further our ambition in the direct and eTrade broker channels where the Group has recently invested and where we believe we will be increasingly competitively advantaged.

# Delivering performance

**John Reizenstein**
Chief Financial Officer

"This year, we met our key financial targets while continuing to invest for the future."

## Highlights

- Operating profit from ongoing operations[1] of £506.0 million for 2014, down 0.8%, (2013: £509.9 million)
- Profit before tax of £456.8 million (2013: £407.3 million) increased 12.2%, reflecting a reduction in restructuring and other one-off costs
- Gross written premium for ongoing operations decreased by 3.8%, reflecting disciplined underwriting in competitive markets
- Combined operating ratio for ongoing operations of 95.0%, an improvement of 0.2 of a percentage point
- Return on tangible equity[2] of 16.8% for 2014 (2013: 16.0%)
- Second special interim dividend of 4.0 pence per share declared and final[3] dividend of 8.8 pence per share proposed

| | 2014 £m | 2013 £m |
|---|---|---|
| **Ongoing operations[1]** | | |
| In-force policies (thousands) | 16,401 | 16,865 |
| Gross written premium | 3,099.4 | 3,222.1 |
| Net earned premium | 2,987.1 | 3,154.1 |
| Underwriting profit | 148.1 | 152.6 |
| Instalment and other operating income | 147.3 | 172.6 |
| Investment return | 210.6 | 184.7 |
| **Operating profit – ongoing operations** | 506.0 | 509.9 |
| Run-off | 55.3 | 63.6 |
| Restructuring and other one-off costs | (69.6) | (140.5) |
| **Operating profit** | 491.7 | 433.0 |
| Finance costs | (37.2) | (37.7) |
| Gain on disposal of subsidiaries | 2.3 | 12.0 |
| **Profit before tax** | 456.8 | 407.3 |
| Tax | (97.5) | (96.5) |
| Profit from discontinued operations, net of tax | 13.3 | 2.0 |
| **Profit after tax** | 372.6 | 312.8 |
| Of which is ongoing operations | 368.0 | 362.4 |
| **Key metrics** | | |
| Loss ratio[1] | 59.6% | 60.9% |
| Commission ratio[1] | 11.8% | 10.6% |
| Expense ratio[1] | 23.6% | 23.7% |
| Combined operating ratio[1] | 95.0% | 95.2% |
| Investment income yield – continuing operations | 2.4% | 2.1% |
| Investment return – continuing operations | 2.9% | 2.4% |
| Basic earnings per share – continuing operations (pence) | 24.0 | 20.8 |
| Adjusted earnings per share[4] – diluted (pence) | 25.5 | 25.0 |
| Return on tangible equity[2] | 16.8% | 16.0% |
| Net asset value per share (pence) | 188.2 | 186.6 |
| Tangible net asset value per share (pence) | 153.1 | 153.2 |
| Dividend per share | | |
| – interim (pence) | 4.4 | 4.2 |
| – final (pence) | 8.8 | 8.4 |
| **– regular (pence)** | 13.2 | 12.6 |
| – first special (pence) | 10.0 | 4.0 |
| – second special (pence) | 4.0 | 4.0 |
| **– total (pence)** | 27.2 | 20.6 |

Notes:

1. See note 2 on page 4
2. See note 1 on page 4
3. Second interim dividend declared in lieu of a final dividend
4. See note 3 on page 5

## Performance

On 25 September 2014, the Group entered into a binding agreement for the sale, subject to regulatory approval, of its International division and accordingly has treated this division as discontinued operations.

### Operating profit – ongoing operations[1]

| | 2014 £m | 2013 £m |
|---|---|---|
| Underwriting profit | 148.1 | 152.6 |
| Instalment and other operating income | 147.3 | 172.6 |
| Investment return | 210.6 | 184.7 |
| Operating profit | 506.0 | 509.9 |

In 2014, operating profit from ongoing operations was stable at £506.0 million (2013: £509.9 million). The underwriting result was marginally lower by 2.9% as lower net earned premium more than offset the improvement in COR to 95.0% (2013: 95.2%). This reflected investment in pricing capability and focus on underwriting discipline. A lower cost base reflecting an ongoing focus on operating efficiency was partly offset by higher profit-share payments to partners. The investment return increase of 14.0%, driven by changes in the asset mix as the Group moved towards its target allocation and favourable unrealised gains on investment property, was offset by lower instalment and other operating income.

### In-force policies and gross written premium

In-force policies – ongoing operations (thousands)

| At 31 December | 2014 | 2013 |
|---|---|---|
| Own brands | 3,415 | 3,466 |
| Partnerships | 257 | 296 |
| **Motor total** | 3,672 | 3,762 |
| Own brands | 1,693 | 1,749 |
| Partnerships | 1,833 | 1,970 |
| **Home total** | 3,526 | 3,719 |
| Rescue | 4,075 | 3,944 |
| Other personal lines | 4,517 | 4,857 |
| **Rescue and other personal lines** | 8,592 | 8,801 |
| **Commercial** | 611 | 583 |
| **Total ongoing** | 16,401 | 16,865 |

During 2014, in-force policies for ongoing operations decreased by 2.8% to 16.4 million. The fall primarily related to other personal lines, within the Rescue and other personal lines division, and Home. The reduction in Rescue and other personal lines was mainly due to fewer Travel policies connected to packaged bank accounts. However, Rescue in-force policies grew by 3.3%, driven by Green Flag's new marketing campaign and propositions.

The reduction in Motor and Home in-force policies of 2.4% and 5.2% respectively reflected the Group's focus on maintaining its underwriting discipline in a competitive marketplace. Within Home, own-brand in-force policies reduced by 3.2% compared to the same period in 2013. This reflected lower new-business volumes, partially offset by a high retention rate.

In-force policy growth in Commercial arose mainly from Direct Line for Business with positive effects from Landlord and Tradesman products, partially offset by a reduction in Van.

Gross written premium – ongoing operations

| | 2014 £m | 2013 £m |
|---|---|---|
| Own brands | 1,248.4 | 1,305.2 |
| Partnerships | 93.6 | 115.9 |
| **Motor total** | 1,342.0 | 1,421.1 |
| Own brands | 416.2 | 434.8 |
| Partnerships | 482.4 | 508.3 |
| **Home total** | 898.6 | 943.1 |
| Rescue | 156.9 | 146.9 |
| Other personal lines | 214.9 | 236.5 |
| **Rescue and other personal lines** | 371.8 | 383.4 |
| **Commercial** | 487.0 | 474.5 |
| **Total ongoing** | 3,099.4 | 3,222.1 |

Gross written premium of £3,099.4 million reduced by 3.8% compared with the prior year (2013: £3,222.1 million). This reflected the impact of competitive motor and home insurance markets, together with the Group's continued focus on maintaining its underwriting discipline.

Gross written premium for Commercial of £487.0 million increased by 2.6% (2013: £474.5 million). The division continued to benefit from previous investments and focus on Direct Line for Business and eTrade. The commercial van market, similar to the personal motor market, remained highly competitive.

### Underwriting profit – ongoing operations

| | 2014 | 2013 |
|---|---|---|
| **Underwriting profit** (£ million) | 148.1 | 152.6 |
| Loss ratio | 59.6% | 60.9% |
| Commission ratio | 11.8% | 10.6% |
| Expense ratio | 23.6% | 23.7% |
| **Combined operating ratio** | 95.0% | 95.2% |

The COR for ongoing operations improved slightly in 2014 to 95.0% (2013: 95.2%) as a lower loss ratio was offset by a higher commission ratio. Adjusted for a normal level of claims from major weather events and including International, the Group's COR was approximately 96%, within the guidance range for 2014 of 95% to 97%.

Note:

1. See note 2 on page 4

Within the overall COR improvement, there was a 1.3 percentage point reduction in the loss ratio. This arose from an improvement in the attritional loss ratio and higher prior-year reserve releases of £397.6 million as a percentage of net earned premium (2013: £395.8 million). Home claims from major weather events decreased by approximately £6 million on the previous year. In 2014, these claims totalled approximately £63 million (2013: approximately £69 million).

During the year, the commission ratio increased by 1.2 percentage points to 11.8% (2013: 10.6%). This was mainly due to profit-share payments due to partners in Motor and Home.

Reflecting the benefit of cost reduction initiatives, which more than offset the effect of lower net earned premium, the expense ratio decreased by 0.1 of a percentage point to 23.6%.

Current-year attritional-loss ratio – ongoing operations

| | 2014 | 2013 |
|---|---|---|
| Reported loss ratio | 59.6% | 60.9% |
| Prior-year reserve releases | 13.3% | 12.6% |
| Major weather events – Home[1] | (2.1%) | (2.2%) |
| **Current-year attritional loss ratio** | **70.8%** | 71.3% |

The movement in the current-year attritional loss ratio is a key indicator of underlying accident year performance as it excludes prior-year reserve movements, and claims from major weather events in the Home division. The Group's current-year attritional loss ratio improved by 0.5 percentage points to 70.8% in 2014 (2013: 71.3%). This reflected improved performance in Home, Commercial and Rescue and other personal lines, partially offset by Motor.

Prior-year reserve releases from ongoing operations continued to be significant at £397.6 million and were a similar level to the previous year (2013: £395.8 million). Prior-year reserve releases were equivalent to 13.3% of net earned premium (2013: 12.6% of net earned premium). If current claims trends continue, the Group expects further significant reserve releases to continue in 2015, albeit the overall level is expected to be lower than in 2014.

By division, the COR improved in Home, Commercial, and Rescue and other personal lines compared with 2013, but deteriorated in Motor.

### Motor

In Motor, the 3.0 percentage points deterioration in the COR principally reflects an increase in the loss and commission ratios. Reserve releases of £278.4 million in 2014 were driven primarily by continued favourable experience on bodily injury claims across recent accident years. This was partly attributable to benefits arising from the Group's claims transformation programme as well as the Legal Aid, Sentencing and Punishment of Offenders Act reforms. The Group believes that it is currently outperforming the industry in respect of small bodily injury claims experience. The current-year attritional loss ratio deteriorated by 3.2 percentage points to 88.5%. This was primarily a result of higher costs for large bodily injury claims in the 2014 accident year, which the Group considers to be due to the intrinsic volatility in this type of claim.

### Home

The COR for the Home division improved to 92.7% in 2014 from 93.8% in the previous year. The current-year attritional loss ratio improved by 1.8 percentage points on the previous year, reflecting the benefits of a disciplined underwriting approach and favourable underlying claims experience. Reserve releases were slightly higher than prior year at £49.8 million (2013: £43.3 million). In 2014, claims from major weather events totalled approximately £63 million compared with approximately £69 million in 2013. This was partially offset by a higher commission ratio reflecting increased profit-share payments due to partners.

Analysis by division

| | Motor | Home | Rescue and other personal lines | Commercial | Total ongoing |
|---|---|---|---|---|---|
| **For the year ended 31 December 2014** | | | | | |
| Combined operating ratio | 96.2% | 92.7% | 92.0% | 98.8% | 95.0% |
| Current-year attritional loss ratio | 88.5% | 49.3% | 61.7% | 69.2% | 70.8% |
| Prior-year reserve releases (£ million)[2] | 278.4 | 49.8 | 15.7 | 53.7 | 397.6 |
| **For the year ended 31 December 2013** | | | | | |
| Combined operating ratio | 93.2% | 93.8% | 92.4% | 106.8% | 95.2% |
| Current-year attritional loss ratio | 85.3% | 51.1% | 62.5% | 74.1% | 71.3% |
| Prior-year reserve releases (£ million)[2] | 291.9 | 43.3 | 9.0 | 51.6 | 395.8 |

Notes:

1. Home claims from major weather events, including inland and coastal flooding, and storms.
2. This excludes the Run-off segment reserve releases of £53.2 million (2013: £52.1 million).

### Rescue and other personal lines

The COR for Rescue and other personal lines improved by 0.4 percentage points to 92.0% (2013: 92.4%), driven by higher prior-year reserve releases on Travel and lower claims frequency in Rescue. In November 2013, the Life business was sold. This contributed £6.4 million to operating profit in the prior year.

### Commercial

The Commercial COR improved to 98.8% from 106.8% in 2013 beating the target set for the division. The 8.0 percentage points improvement in the COR was mainly due to better underlying underwriting performance, and better expense and commission ratios. The current-year attritional loss ratio improved, demonstrating the positive effect of disciplined underwriting and the non-repeat of the above average level of large claims experienced in 2013. The division continued experiencing significant prior-year reserve releases, which were slightly higher than in 2013.

### Total cost base

| | 2014 £m | 2013 £m |
|---|---|---|
| Staff costs | 247.6 | 297.8 |
| Marketing | 123.9 | 159.1 |
| Depreciation | 22.6 | 18.4 |
| Amortisation and impairment of other intangible assets | 66.4 | 33.6 |
| Other operating expenses | 244.9 | 237.9 |
| **Total operating expenses – ongoing** | 705.4 | 746.8 |
| Claims handling expenses | 222.3 | 238.2 |
| **Total cost base – ongoing** | 927.7 | 985.0 |
| Total operating expenses – discontinued | 29.0 | 39.6 |
| Claims handling expenses – discontinued | 17.2 | 7.3 |
| **Total cost base – ongoing and discontinued operations** | 973.9 | 1,031.9 |

The Group achieved its target total cost base of approximately £1,000 million in 2014 with a total cost base of £973.9 million including the International division which is now treated as a discontinued operation.

The total cost base for ongoing operations of £927.7 million was 5.8% lower than last year (2013: £985.0 million). The reduction was principally due to the Group's cost-savings initiatives, with a continuing focus on cost control and operating efficiency, including marketing. Overall, the expense ratio reduced 0.1 of a percentage point to 23.6%, with the reduction in operating expenses partially offset by the impact of lower net earned premium.

### Instalment and other operating income – ongoing operations

| | 2014 £m | 2013 £m |
|---|---|---|
| **Instalment income** | 100.4 | 111.0 |
| Other operating income: | | |
| Vehicle replacement referral income | 15.8 | 15.7 |
| Revenue from vehicle recovery and repair services[1] | 18.0 | 31.8 |
| Fee income from insurance intermediary services | 2.1 | 1.7 |
| Other income[2] | 11.0 | 12.4 |
| **Other operating income** | 46.9 | 61.6 |
| **Total ongoing** | 147.3 | 172.6 |

Instalment and other operating income from ongoing operations reduced by 14.7% on 2013. This was mainly due to the sale of the Tracker business, cessation of solicitors' referral fee income from 1 April 2013 and lower instalment income.

Instalment income, which represents interest charged on insurance premiums paid by instalments, of £100.4 million reduced by £10.6 million compared with the prior year (2013: £111.0 million). This was a result of lower in-force policies and gross written premium in Motor and Home.

In February 2014, the Group sold its stolen-vehicle recovery business, Tracker. In 2014, Tracker's revenue prior to sale was £1.4 million (2013: £18.4 million), which was included in the above. Operating losses from the business were £0.4 million (2013: loss of £1.4 million).

### Investment return – ongoing operations

| | 2014 £m | 2013 £m |
|---|---|---|
| Investment income | 171.7 | 157.1 |
| Net realised and unrealised gains | 38.9 | 27.6 |
| **Investment return – ongoing** | 210.6 | 184.7 |

Investment yields – continuing operations[3]

| | 2014 | 2013 |
|---|---|---|
| Investment income yield[4] | 2.4% | 2.1% |
| Investment return[5] | 2.9% | 2.4% |

The total investment return for ongoing operations increased to £210.6 million compared to £184.7 million in 2013. This was driven by both an increase in investment income and net realised and unrealised gains. Investment income was £171.7 million, a 9.3% increase from 2013, as a result of changes in asset mix, which were partially offset by both lower assets under management ("**AUM**") and market yields. Net realised

Notes:

1. Vehicle recovery includes post-accident and pay-on-use recovery, and vehicle tracking. Repair services include providing non-insurance related repairs.
2. Includes referral fees and legal income
3. Includes continuing operations and the Run-off segment
4. Investment income yield excludes net gains and is calculated on income divided by calculating the average AUM based on the opening and closing balance for total Group – continuing operations.
5. Investment return includes net gains and is calculated on income divided by calculating the average AUM based on the opening and closing balance for total Group – continuing operations.

and unrealised gains from ongoing operations of £38.9 million were higher than the previous year (2013: £27.6 million gain) primarily due to fair value increases on investment property (2014: £25.9 million; 2013: £7.6 million) with lower realised gains on fixed income debt securities (2014: £15.8 million; 2013: £20.5 million gain).

The investment income yield for continuing operations in 2014 was 2.4%, compared to 2.1% in 2013. This reflects portfolio actions which increased investments in UK commercial property, securitised credit and non-investment grade credit within the corporate debt portfolio and infrastructure debt as the Group moved towards its target asset allocation. Based on current yield curves and the current target asset allocation, the Group forecasts 2016 investment income yield of 2.7%.

Total investment holdings excluding International reduced by 8.3% in 2014, primarily reflecting a reduction in gross written premium and payment of the £149.7 million special interim dividend on 12 September 2014. Portfolio changes are outlined on page 47. Total unrealised gains excluding International and net of tax, on available-for-sale ("AFS") investments were £94.4 million at 31 December 2014 (31 December 2013: £50.3 million).

### Operating profit – ongoing operations

| | 2014 £m | 2013 £m |
|---|---|---|
| Motor | 297.1 | 347.7 |
| Home | 113.9 | 106.2 |
| Rescue and other personal lines | 48.0 | 46.5 |
| Commercial | 47.0 | 9.5 |
| **Total ongoing** | **506.0** | 509.9 |

All divisions were profitable in 2014, with all areas except Motor improving operating profit compared to the previous year.

### Reconciliation of operating profit

| | 2014 £m | 2013 £m |
|---|---|---|
| **Operating profit – ongoing** | **506.0** | 509.9 |
| Run-off | **55.3** | 63.6 |
| Restructuring and other one-off costs | **(69.6)** | (140.5) |
| **Operating profit** | **491.7** | 433.0 |
| Finance costs | **(37.2)** | (37.7) |
| Gain on disposal of subsidiaries | **2.3** | 12.0 |
| **Profit before tax** | **456.8** | 407.3 |
| Tax | **(97.5)** | (96.5) |
| Profit from discontinued operations, net of tax | **13.3** | 2.0 |
| **Profit after tax** | **372.6** | 312.8 |

### Run-off

The Run-off segment generated a profit of £55.3 million in 2014 compared with £63.6 million in 2013. Improved claims experience, particularly from large bodily injury, led to a similar level of prior-year reserve releases to 2013. It is currently expected that the Run-off segment will contribute positively to operating profit in future years; however, at a lower level than in 2014.

### Restructuring and other one-off costs

Restructuring and other one-off costs for 2014 of £69.6 million (2013: £140.5 million) primarily related to costs associated with migrating the Group's IT infrastructure. The reduction was mainly due to lower costs arising from the Group's cost savings initiatives.

For 2015, the Group expects to incur additional restructuring costs in the region of £50 million as it concludes the IT migration as well as costs associated with ongoing cost reduction initiatives including the exit of one location announced earlier in 2015.

Over the next three years, the Group expects cumulative restructuring costs to be substantially offset by the profit from the Run-off segment.

### Finance costs

Finance costs remained stable at £37.2 million (2013: £37.7 million).

### Gain on disposal of subsidiaries

The gain on disposal of £2.3 million relates to selling the Group's stolen vehicle recovery business, Tracker.

### Taxation

The effective tax rate for continuing operations in 2014 was 21.3% (2013: 23.7%), aligning closely with the standard UK corporation tax rate of 21.5% (2013: 23.25%). The difference in rate was driven primarily by disallowed expenses, the non-taxable disposal of subsidiaries and adjustments to provisions in respect of prior-year tax.

### Discontinued operations

On 25 September 2014, the Group announced a binding agreement for the sale of its International division to Mapfre, S.A. for total cash proceeds of €550.0 million (£430.1 million[1]). The results from this division are now treated as discontinued operations.

Gross written premium for discontinued operations of £567.6 million was 6.1% lower than the previous year, mainly due to foreign currency movements. Gross written premium in local currency terms fell marginally by 1.7%, as competitive markets in Italy were partially offset by Germany's expanding share of business incepting on 1 January 2014.

Note:

1. See note 2 on page 5

The discontinued operations' COR in 2014 improved to 102.1% from 103.9% in 2013. The loss ratio improved by 3.1 percentage points reflecting a decrease in claims frequency in Italy and non-repeat of claims from severe hailstorms which affected Germany in 2013.

Overall, the operating profit for discontinued operations increased by 26.5% to £21.0 million in 2014 (2013: £16.6 million).

Further details on discontinued operations are presented in note 5 to the consolidated financial statements, see page 133.

### Profit for the year and return on tangible equity

Profit for the year amounted to £372.6 million (2013: £312.8 million), an increase of 19.1% on 2013.

RoTE increased to 16.8% (2013: 16.0%) in part from a lower capital base as the Group returned surplus capital to shareholders.

### Earnings per share

Basic earnings per share for continuing operations of 24.0 pence increased by 15.4% (2013: 20.8 pence). This reflected a decrease in restructuring and other one-off costs, partially offset by lower operating profit from the Run-off segment and a lower effective tax rate.

Adjusted diluted earnings per share, which includes ongoing operations and the International division, increased marginally by 2.0% to 25.5 pence (2013: 25.0 pence).

### Dividends

The Board has resolved this year to pay an interim dividend in lieu of a final dividend of 8.8 pence per share (2013: 8.4 pence), making total regular dividends for 2014 of 13.2 pence per share (2013: 12.6 pence). This represents an increase of 4.8% on the 2013 regular dividend and is in line with the Group's aim to grow dividends annually in real terms.

Given the proximity of the 2014 final dividend to the expected special dividend relating to the sale of the International division, as an exception to the usual process, the final dividend will be accelerated and, as referred to above, the Board has resolved to pay it as an interim dividend. This should avoid potential delays in payment to shareholders, which might otherwise arise following the sale of the International business.

The Board has also resolved to pay a second special interim dividend of 4.0 pence per share. This is in addition to the 10.0 pence per share special dividend paid in September 2014. This return of capital is consistent with the Group's policy to distribute surplus capital. The ex-dividend date for both the final and second special dividends is 12 March 2015 and the record date is 13 March 2015. The dividends' payment date is 17 April 2015.

Moreover, the Board currently expects to propose, following completion of the sale of the Group's International division, a further special interim dividend of substantially all the net proceeds. This return of capital will be conditional on shareholders approving a share consolidation designed to neutralise the effect on the share price of this return of capital and to maintain comparability of per share data.

## Cash flow

Net cash used by operating activities before investing insurance assets increased to £410.6 million (2013: £307.0 million). This reflected an increase in cash used by operations to £315.2 million (2013: £226.6 million) and an increase of taxes paid to £94.8 million (2013: £80.2 million). The increase in cash used by operations resulted from a decrease in trade and other payables, including insurance payables of current and prior-year claims.

During the year, cash generated from investing insurance assets increased to £1,121.1 million (2013: £433.0 million). Net cash proceeds from the disposal, maturity and purchases of AFS financial investments were £496.7 million (2013: £274.9 million cash used). Interest received decreased by £215.7 million (2013: £574.2 million).

Overall, net cash generated from operating activities totalled £710.5 million (2013: £126.0 million).

Net cash used by investing activities of £216.0 million (2013: £145.3 million) primarily comprised of purchasing intangibles relating to ongoing software investment, and purchasing property, plant and equipment relating to freehold land and buildings.

Dividends paid amounted to £401.1 million (2013: £242.7 million), representing payment of the final 2013 and interim and first special interim 2014 dividends. Following these, net cash used by financing activities totalled £443.4 million (2013: £544.7 million).

Overall, cash and cash equivalents increased by £51.1 million (2013: £564.0 million decrease) across the year to £898.2 million (31 December 2013: £853.2 million).

## Net asset value

| At 31 December | 2014 £m | 2013 £m |
|---|---|---|
| Net assets | 2,810.5 | 2,790.0 |
| Goodwill and other intangible assets | (523.1) | (500.1) |
| **Tangible net assets** | 2,287.4 | 2,289.9 |
| Net asset value per share (pence) | 188.2 | 186.6 |
| Tangible net asset value per share (pence) | 153.1 | 153.2 |

The net asset value at 31 December 2014 was £2,810.5 million (31 December 2013: £2,790.0 million) with tangible net asset value of £2,287.4 million (31 December 2013: £2,289.9 million). This equates to 188.2 pence and 153.1 pence per share respectively at 31 December 2014 (31 December 2013: 186.6 pence and 153.2 pence, respectively).

The marginal increase in net asset value principally reflects profit for the period and increase in unrealised gains on AFS investments offset by dividend payments.

## Financial management

Accessing sufficient funding as liabilities fall due is central to the Group's long-term sustainability. The Group's integrity and brand reputation for customers and other stakeholders relies on this sustainability. The Group's key financial risks are reserving for insurance liabilities and market risk connected to the investment portfolio.

### Reserving

Financial management includes the central aspect of estimating claims reserves. Uncertainty is an inherent part of insurance and requires judgement when assessing claims liabilities. The Group considers the class of business, the length of time to notification of a claim, the validity of the claim against a policy, and the claim value. Claims reserves could settle at a range of outcomes, and settlement certainty increases over time. However, for bodily injury claims, the uncertainty is greater due to the length of time taken to settle these claims. Lifetime indexed payments for injured parties also increase this uncertainty.

The Group seeks to adopt a conservative approach to assessing liabilities as evidenced by the favourable development of historical claims reserves. Reserves are based on management's best estimate which incorporates a prudent margin in excess of the internal actuarial best estimate. This margin is made in reference to a range of actuarial scenario assessments and percentiles and also considers other short and long-term risks not reflected in the actuarial inputs. For more information, see pages 149 to 152.

The significant level of recent prior-year reserve releases has arisen primarily from improvements in the actuarial best estimate, while the percentage margin above actuarial best estimate has increased over the same period. Looking forward, the Group will continue to set its initial management best estimate for future accident years conservatively, but provided that the risk outlook remains stable, it does not expect to need to increase further the overall margin. Over time, the share of the Group's underwriting profit attributable to current year is expected to increase. Assuming current claims trends continue, the contribution from prior-year reserve releases is expected to remain significant, albeit lower than in 2014.

### Claims reserves net of reinsurance

| At 31 December | 2014 £m | 2013 £m |
|---|---|---|
| Motor | 2,355.1 | 2,606.3 |
| Home | 335.2 | 398.1 |
| Rescue and other personal lines | 77.0 | 77.4 |
| Commercial | 607.5 | 637.9 |
| **Total ongoing** | 3,374.8 | 3,719.7 |
| Run-off | 523.8 | 682.2 |
| International | 393.6 | 438.2 |
| **Total Group** | 4,292.2 | 4,840.1 |

### Taxation

The Board recognises that the Group has an important responsibility to its stakeholders to manage its tax position effectively. The Board has delegated day-to-day management of taxes to the Chief Financial Officer and oversight is provided by the Audit Committee.

These arrangements are intended to ensure that: the Group complies with applicable laws and regulations, and meets its obligations as a contributor of taxes and a collector of taxes on behalf of the tax authorities; and manages its tax affairs efficiently, claiming reliefs and other incentives where appropriate.

### Investment portfolio

The total value of the investment portfolio excluding the International division's portfolio at 31 December 2014 was £7,051.3 million, 8.3% lower than at 31 December 2013. The investment income yield on the portfolio for 2014 was 2.4%, an increase of 0.3 percentage points compared to previous year.

The investment strategy is designed to deliver several objectives, which are summarised below:

- To ensure there is sufficient liquidity available within the investment portfolio to meet stressed liquidity scenarios determined by the Risk function
- To duration match non-PPO liabilities
- To back inflation-linked PPO liabilities with growth assets and other appropriate long-term assets expected to generate long-term returns in line with claims requirements
- To deliver a suitable risk adjusted investment return commensurate with the Group's risk appetite

### Asset and liability management

The following table summarises the Group's high level approach to asset and liability management.

| Liabilities | Asset | Characteristics |
|---|---|---|
| More than 10 years, for example PPOs | Property and infrastructure debt | Inflationary linked or floating |
| Short and medium term – all other claims | Investment-grade credit and short-term high yield | Key rate duration matched |
| Tier 2 sub-debt (swapped fixed to floating) | Securitised credit and cash | Floating |
| Surplus – tangible equity | Investment-grade credit, cash and government debt securities | Fixed or floating |

Key highlights in 2014 included:

- The introduction of two new asset classes with an intention for a third. The allocation to infrastructure debt supports the asset strategy backing PPO liabilities. Allocations to high yield and private placement credit help support delivering an improved risk adjusted return. After identifying external asset managers for each mandate, infrastructure debt funding commenced in the year, the high-yield credit mandate was fully funded and the private placement investments will commence in early 2015
- The wider use of pooled liquidity products to support returns from cash and cash equivalents
- The regular use of the internal economic capital model to determine the capital implications for all asset changes proposed and to support Investment Committee and Board decision making
- Updated management reporting and redefined key risk indicators covering investment activities

## Asset allocation and benchmarks

The present strategic asset benchmarks for the Group's principal UK general insurance underwriter, U K Insurance Limited ("**UKI**"), are detailed in the following table:

| At 31 December | Current benchmark holding | 2014 |
|---|---|---|
| Investment-grade credit | 55.0% | 58.2% |
| High yield | 4.0% | 4.0% |
| Investment-grade private placements | 4.0% | – |
| **Credit** | 63.0% | 62.2% |
| Securitised credit | 6.0% | 6.0% |
| Sovereign | 13.0% | 14.1% |
| **Total debt securities** | 82.0% | 82.3% |
| Infrastructure | 6.0% | 1.1% |
| Investment property | 5.0% | 4.3% |
| Cash[1] and cash equivalents | 7.0% | 12.3% |
| **Total** | 100.0% | 100.0% |

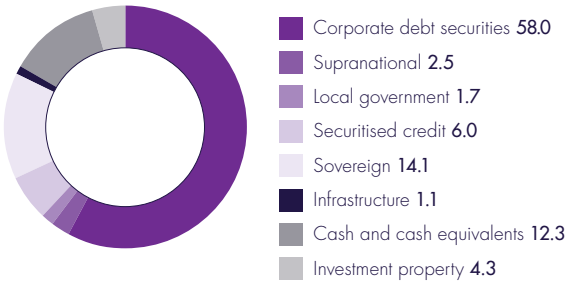
Total debt securities, excluding the International division's investment portfolio, are £5,802.5 million (2013: £6,266.3 million), of which 13.5% are rated as 'AAA' and a further 65.2% are rated as 'AA' or 'A'. Corporate, local government and supranational debt securities account for 75.6% of the debt securities portfolio. The average duration at 31 December 2014 of total debt securities was 2.1 years (2013: 2.3 years).

During 2014, the Group reduced its allocation in investment grade credit by four percentage points, and allocated the funds to high-yield credit rated 'BB' and 'B'. A further reallocation of funds is planned for 2015 with another four percentage points reduction in existing investment grade credit (public debt issues) and allocation to investment grade private placements.

Derivatives are permitted only for risk mitigation and efficient portfolio management within the investment portfolio. Derivatives used include interest rate swaps, for example to hedge exposure to US Dollar interest rate movements, and forward currency contracts to hedge assets denominated in US Dollars back to Pounds Sterling. Separately, interest rate swaps have also been used to change the interest rate liability on the Group's debt issuance to a floating rate basis. Furthermore, Euro cash proceeds to be received from the expected sale of the International division have been hedged to Pounds Sterling within the designated foreign currency hedge contract.

### Investment portfolio as at 31 December 2014

(%)




### Investment portfolio as at 31 December 2013

(%)

Note:

1. Awaiting investment into investment property, investment grade private placements and infrastructure.

### Investment holdings and yields – total Group

| £m | 2014 Allocation | 2014 Income | 2013 Allocation | 2013 Income |
|---|---|---|---|---|
| Corporate[1] | 4,092.7 | 118.2 | 4,248.6 | 111.8 |
| Supranational | 176.2 | 4.9 | 330.5 | 6.8 |
| Local government | 120.3 | 2.4 | 134.5 | 2.9 |
| **Credit** | 4,389.2 | 125.5 | 4,713.6 | 121.5 |
| Securitised credit[1] | 419.6 | 6.1 | 184.0 | 0.3 |
| Sovereign | 993.7 | 22.4 | 1,368.7 | 30.1 |
| **Total debt securities** | 5,802.5 | 154.0 | 6,266.3 | 151.9 |
| Infrastructure | 76.2 | 0.1 | – | – |
| Cash[2] | 865.4 | 5.2 | 1,199.4 | 6.9 |
| Investment property | 307.2 | 16.2 | 223.4 | 11.4 |
| **Total excluding International** | 7,051.3 | 175.5 | 7,689.1 | 170.2 |
| International[3] | – | – | 868.5 | 18.4 |
| **Total Group** | 7,051.3 | 175.5 | 8,557.6 | 188.6 |

| | 2014 Weighting | 2014 Yield | 2013 Weighting | 2013 Yield |
|---|---|---|---|---|
| Corporate[1] | 58.0% | 2.8% | 49.6% | 2.8% |
| Supranational | 2.5% | 1.9% | 3.9% | 1.6% |
| Local government | 1.7% | 1.9% | 1.6% | 1.5% |
| **Credit** | 62.2% | 2.8% | 55.1% | 2.6% |
| Securitised credit[1] | 6.0% | 2.0% | 2.2% | 0.4% |
| Sovereign | 14.1% | 1.9% | 16.0% | 1.9% |
| **Total debt securities** | 82.3% | 2.6% | 73.3% | 2.4% |
| Infrastructure | 1.1% | 0.3% | – | – |
| Cash[2] | 12.3% | 0.5% | 14.0% | 0.4% |
| Investment property | 4.3% | 6.1% | 2.6% | 6.5% |
| **Total excluding International** | 100.0% | 2.4% | 89.9% | 2.1% |
| International[3] | – | – | 10.1% | 2.2% |
| Total Group | 100.0% | 2.4% | 100.0% | 2.1% |

## Capital management

### Capital management policy

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

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

Where the Board believes the Group has capital that is surplus to requirements, it looks to return it to shareholders. For example, this may occur if it expected that the risk-based capital coverage would be significantly above the 125% to 150% target range for a prolonged period.

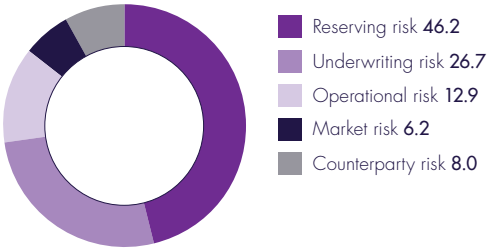
### Risk-based capital

For UKI, the Group uses its own risk-based capital model to determine the level of capital required to operate within its risk appetite. The internal model is calibrated to a 99.5% confidence interval and considers earned business and future business written over a one-year period. Additionally, the model allows for the uncertainty around this business until ultimate settlement. This approach is consistent with the individual capital assessment ("**ICA**") methodology set by the Prudential Regulation Authority ("**PRA**").

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

### Capital allocated by risk type

(%)




### Capital position and leverage

| At 31 December | 2014 £m | 2013 £m |
|---|---|---|
| **Consolidated statutory solvency capital** | | |
| Shareholders' equity | 2,810.5 | 2,790.0 |
| Goodwill and other intangible assets | (523.1) | (500.1) |
| Regulatory adjustments | (28.1) | 6.2 |
| **Total tier 1 capital** | 2,259.3 | 2,296.1 |
| Lower tier 2 capital[4] | 496.1 | 496.9 |
| Regulatory adjustments | (54.6) | (28.9) |
| **Total regulatory capital** | 2,700.8 | 2,764.1 |
| Less: final and special dividends | (192.0) | (186.0) |
| **Adjusted regulatory capital** | 2,508.8 | 2,578.1 |

Notes:

1. Allocation at 31 December 2014 includes investment-portfolio derivatives, which have been netted and have a mark-to-market liability value of £27.8 million, split £24.4 million in corporate-debt securities, £0.1 million in supranationals, £0.4 million in local government, £2.8 million in securitised credit and £0.1 million in sovereign (31 December 2013: mark-to-market asset value £39.8 million, split £37.7 million corporate-debt securities and £2.1 million securitised credit). This excludes non-investment derivatives used to hedge subordinated debt, operational cash flows and the pending disposal of the International division.
2. Net of bank overdrafts and including term deposits with financial institutions with maturities exceeding three months.
3. Income included in discontinued operations in 2013
4. Includes that element of the subordinated guaranteed dated notes applicable for regulatory capital purposes

The Group is well capitalised with key capital metrics within the Group's risk appetite and significantly above regulatory minima. The regulatory numbers are estimated, based on preliminary regulatory returns for 31 December 2014.

| At 31 December | 2014 | 2013 |
|---|---|---|
| Insurance Group Directive ("IGD") coverage ratio | 347.4% | 291.6% |
| Risk-based capital-coverage ratio | 158.9% | 158.7% |
| Risk-based capital-coverage ratio (adjusted for final and special dividends) | 148.2% | 148.7% |

At 31 December 2014, the Group had an estimated risk-based capital-coverage ratio of 158.9% (31 December 2013: 158.7%). This reduces to 148.2% after deducting the proposed final and special interim dividends (31 December 2013: 148.7%). On an IGD basis, the coverage is 347.4% (31 December 2013: 291.6%).

The following table sets out the Group's financial leverage ratio. The Group's leverage ratio remains conservative with a financial leverage of 15.8% at 31 December 2014 (31 December 2013: 14.9%).

| At 31 December | 2014 £m | 2013 £m |
|---|---|---|
| Shareholders' equity | 2,810.5 | 2,790.0 |
| Financial debt – subordinated guaranteed dated notes | 526.3 | 486.6 |
| **Total capital employed** | 3,336.8 | 3,276.6 |
| Financial-leverage ratio[1] | 15.8% | 14.9% |

### Credit ratings

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

### Solvency II

With effect from 1 January 2016 the basis on which the Group will assess its regulatory capital position will move from ICA to Solvency II. As part of this transition, the Group will consider any changes it should make to its risk-based capital metrics to align these more closely to Solvency II. This will include reviewing the Group's risk appetite and, if necessary, recalibrating it.

### Current capital position and outlook

The Group has continued to manage its capital base actively during 2014 with a special interim dividend of 10.0 pence per share paid in September 2014. The Board has resolved to pay a second special interim dividend of 4.0 pence per share. The first and second special interim dividends have resulted from the build up of surplus capital, in part reflecting the Group's disciplined approach to underwriting over the last few years.

A final dividend of 8.8 pence per share, which the Board has resolved to pay this year as an interim dividend, represents 4.8% growth on 2013. Total regular dividends for 2014 of 13.2 pence per share represent 4.8% growth on 2013 and are in line with the Group's policy to aim to increase the dividend annually in real terms.

Since the IPO, the Group has paid dividends equivalent to 24.6% of its IPO price to shareholders, and this figure will rise to 31.9% when the final and second special interim dividends are included.

After deducting these dividends, the Board considers that the Group is strongly capitalised with a risk-based capital coverage ratio at the upper end of its target range. It also has an 'A' rating with stable outlook from its credit rating agencies.

The Board's view of the capital position takes into account the transition to a Solvency II environment and considers the Group's position on the standard formula, which it is expected to operate under for at least the first six months of 2016, and the Internal Economic Capital Model. In view of the transition to Solvency II, the Board is likely to next consider any return of capital alongside the full-year results for 2015. The consideration of any future return of capital that the Board may decide to make will take into account the Group's requirements on a Solvency II basis and, in line with its existing policy, will consider capital requirements over a prolonged period.

Notwithstanding the above, following the completion of the sale of the International division, and as indicated at the time of the announced sale in September 2014, the Board expects to announce a special interim dividend of substantially all of the net proceeds. This return of capital will be conditional on shareholders approving a share consolidation designed to neutralise the effect on the share price of this return of capital and to maintain comparability of per share data.

## Statement of the Directors in respect of the Strategic report

The Board reviewed and approved our Strategic report on pages 2 to 49 on 2 March 2015.

By order of the Board

**Paul Geddes**
Chief Executive Officer
2 March 2015

**John Reizenstein**
Chief Financial Officer
2 March 2015

Note:

1. Total financial debt as a percentage of total capital employed

# Corporate governance

**Mike Biggs,**
Chairman

"We have a strong team in place to continue delivering our strategy, to capitalise on opportunities and meet the challenges ahead."

## Dear shareholders and other stakeholders

### Our commitment to good corporate governance

As Chairman, I want to ensure that Direct Line Group is well governed. I am pleased to report that we have complied with substantially all of the provisions of the UK Corporate Governance Code (September 2012). The Board has worked hard during the year seeking to ensure that high governance standards have been maintained throughout the Group.

The following Corporate governance report gives shareholders a clear and comprehensive view of the Group's governance arrangements and how we have operated within them over the past year.

### The way we do business

The way we do business and our underlying values are central to Direct Line Group's success. Our Code of Business Conduct governs the way we interact with our stakeholders and our values determine our behaviours. Both determine how we do business throughout the Group and define our corporate identity. They also influence our business relationships and reputation, which are key to our long-term success. Our Code of Business Conduct is set out below, our values are on the following page and you can also view them and our Ethical Code for Suppliers at www.directlinegroup.com .

### Relationship with RBS Group

It was another significant year for Direct Line Group. On 27 February 2014, RBS Group sold its entire remaining shareholding in the Company, save for a small number of shares it retained to satisfy long-term incentive awards issued by RBS Group to Direct Line Group management. As explained in last year's Annual Report, a European Commission obligation required RBS Group to sell its shareholding by the end of 2014. As such, Direct Line Group is no longer owned by RBS Group and our operations are now largely separate. The sale does not affect our business strategy. We will continue our journey towards our goal of becoming the leading personal and small business general insurer in the UK.

## Our Code of Business Conduct

**Business practices**
We shall engage in honest, professional and ethical conduct and maintain effective procedures to prevent confidential information being misused.

**Dealing with customers**
We shall treat customers fairly, openly and honestly, and operate an effective complaints process to address any perceived departure from these standards.

**Dealing with shareholders and other stakeholders**
We shall seek to maximise shareholder value over time, recognising that wealth generated also benefits customers, employees and the communities where we operate.

**Dealing with employees**
We shall maintain a working environment that attracts, motivates and retains employees, and shall be intolerant of any type of discrimination, harassment or victimisation.

## Board composition

A number of changes in the composition of the Direct Line Insurance Group plc Board took place during 2014. Following RBS Group's sale of substantially all of its shareholding in the Company, Mark Catton, RBS Group's nominated Non-Executive Director, stepped down on 7 March 2014.

I would like to thank Mark for his excellent contribution to the Company during his time on the Board and wish him well in the future.

Following a review of the Board's balance of skills, knowledge and experience, and a rigorous selection process, Sebastian James joined the Board on 28 August 2014. With digital marketing and customer service increasingly important to our business, Sebastian brings valuable experience in these fields and is an important addition to the Board. On behalf of the Board, I am delighted to welcome him as a Non-Executive Director of the Company.

You can find further information on diversity at Board level and the Board effectiveness review in the Corporate governance report on page 57.

I am confident we have a strong team in place to continue delivering our strategy, capitalise on the opportunities and meet the challenges ahead.

**Michael N Biggs,** Chairman
2 March 2015

## Our values

### Do the right thing

For our people, our customers, our shareholders and our wider stakeholders; make decisions based on what is right, not what is easy; demonstrate personal and professional integrity; do what's right for the long-term sustainability of our business.

### Aim higher

Strive to be the best in every area of the business; be ambitious, courageous and innovative; relentlessly challenge and improve; seek and embrace change; learn from our mistakes; persevere, always deliver our promises and don't settle for second best.

### Work together

Collaborate across all levels and across all functions; leverage the skills, knowledge and experience, irrespective of hierarchy, to deliver the best possible results; develop relationships based upon trusting each other, partnerships and win-wins; recognise and celebrate success.

### Take ownership

Treat it like it's OUR business; take the initiative, if you can see a better way, go and make a difference; take decisions, be accountable for your actions in whatever role you carry out; take responsibility for your own personal development and performance.

### Say it like it is

Be real, authentic and true to self; have adult to adult conversations with all audiences; listen, seek to understand and respect diversity of views; be open, call out issues we see; share information and keep things as simple as possible.

### Bring all of yourself to work

Be the best you can be, the real and whole you; celebrate our diversity of skills, experiences and personalities; be a role model to others, demonstrate 'can do' spirit, have fun and make this a great place to be; be excited about our Company and our future; believe in yourself, feel confident and empowered.

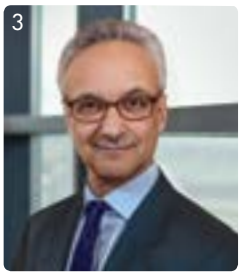
**Dealing with suppliers of goods and services and business partnerships**
We shall maintain the highest possible standards of integrity in business relationships with suppliers and partners by treating them honestly and with respect, and avoiding compromising offers of gifts and hospitality.

**Dealing with communities and the environment**
We shall contribute to the social and economic well-being of those communities where we are an employer, and encourage employees to participate in projects and initiatives to strengthen those communities.

**Dealing with competitors**
We shall compete with competitors honestly and in accordance with the relevant competition law.

**Dealing with regulators**
We shall maintain a constructive and open relationship with our regulators to foster mutual trust, respect and understanding, and will not offer anything to officials in return for favourable treatment.

# Board of Directors



**1 Mike Biggs (62),** Chairman of the Board (appointed April 2012) [N and R]

Biography

Mike is also Chair of the Nomination Committee. He has over 40 years' experience of the UK and international financial services sector. He is a respected figure in the insurance industry and is well regarded by City investors.

Mike was previously Chairman of Resolution Limited, the FTSE 100 UK life assurance business, and has acted as Chief Executive Officer and Group Finance Director of Resolution plc. He was previously Group Finance Director of Aviva plc.

He has a Masters degree in History from the University of Oxford and is an Associate of the Institute of Chartered Accountants in England and Wales.

External appointments

None

**2 Paul Geddes (45),** Chief Executive Officer (appointed August 2009) [C]

Biography

Paul is Chief Executive Officer. His experience in leading one of the UK's largest retail banking businesses during a challenging period for the industry and improving its customer and financial performance against peers singled him out in 2009 as the Chief Executive able to lead the turnaround of Direct Line Group and its divestment from RBS Group.

He was the Chief Executive Officer of RBS Group's mainland UK retail banking business, having joined in 2004 as Managing Director with responsibility for products and marketing. Before joining RBS Group, Paul held a number of senior roles in multi-channel retailing in the GUS and Kingfisher groups. Paul started his career in marketing, with UK and European roles at Procter & Gamble. Paul read Philosophy, Politics and Economics at the University of Oxford. He is a Fellow of the Chartered Institute of Bankers in Scotland.

External appointments

Paul is a member of the Association of British Insurers' Board, a member of the Financial Ombudsman Service's insurance industry steering group, and a member of the Financial Conduct Authority's Practitioner Panel.

**3 John Reizenstein (58),** Chief Financial Officer (appointed December 2010)

Biography

John is an experienced Chief Financial Officer and former banker with extensive City and financial services experience.

John was previously an Executive Director at the Co-operative Insurance Society, CIS General Insurance and The Co-operative Bank. He was Chief Financial Officer of these entities between 2003 and 2007, and subsequently Managing Director, Corporate and Markets. Prior to that, John spent more than 20 years in investment banking with UBS and Goldman Sachs. He is an Economics graduate of the University of Cambridge.

External appointments

John is a trustee and director of Farm Africa and is an alternate representative of the Association of British Insurers on the Panel on Takeovers and Mergers.

**4 Glyn Jones (62),** Senior Independent Non-Executive Director (appointed September 2012) [A, I, N and +]

Biography

Glyn is Chair of the Investment Committee. He has undertaken a number of senior roles within the financial services industry and, as a former Chief Executive Officer in the asset management industry, he also understands the City and shareholders well.

Glyn was Chairman of Towry Holdings Limited between 2006 and 2011 and Chairman of Aspen UK from 2007 to 2014. He also served as Chairman of Hermes Fund Managers from 2008 to 2011 and was Chairman of its sister company, BT Pension Scheme Management, for a part of this period. Glyn was Chief Executive Officer of the independent investment group, Thames River Capital, from 2005 to 2006. From 2000, he served as Chief Executive Officer of Gartmore Investment Management in the UK for four years. Before this, Glyn was Chief Executive Officer of Coutts NatWest Group and Coutts Group, having joined in 1997. Glyn joined Standard Chartered in Hong Kong in 1990 where he became the General Manager of Global Private Banking. He was a consulting partner with Coopers & Lybrand/Deloitte Haskins & Sells Management Consultants from 1981 to 1990. He is a graduate of the University of Cambridge and a Fellow of the Institute of Chartered Accountants in England and Wales.

External appointments

Glyn is Chairman of Aspen Insurance Holdings Limited, a New York listed specialty lines insurer. He is also Chairman of Aldermore Group plc and its subsidiary Aldermore Bank plc.

**5 Jane Hanson (47),** Non-Executive Director (appointed December 2011) [A, B, C, I and +]

Biography

Jane is Chair of the Board Risk Committee. She has extensive experience of risk management, corporate governance and internal control. She also has extensive experience of developing and monitoring customer frameworks.

She spent 12 years with KPMG, where she worked in the financial sector, becoming the Director responsible for delivery of corporate governance, internal audit and risk management services in the North of England. Jane has also held executive roles including Director of Audit, and Risk and Governance Director at Aviva's UK Life business. She is a graduate of the University of York with a degree in Music and is a Fellow of the Institute of Chartered Accountants in England and Wales.

External appointments
Jane is Chair of Reclaim Fund Ltd and a Non-Executive Director of Old Mutual Wealth Management Limited. She is also an Independent Member of the Fairness Committee at ReAssure Ltd.

She has her own financial sector consulting business, delivering audit, enterprise risk management and corporate governance advisory and consulting services. She is also a magistrate.

**6 Sebastian James (48),** Non-Executive Director (appointed August 2014) (C, R and +)

Biography
Sebastian is Group Chief Executive of Dixons Carphone plc and has held a number of senior strategic and operational positions in the retail, consulting and insurance sectors.

Sebastian was Group Chief Executive of Dixons Retail plc from 2012 until its merger with Carphone Warehouse Group plc on 6 August 2014. Before this, Sebastian was Chief Executive Officer of Synergy Insurance Services Limited, a private equity backed insurance company, and was previously Strategy Director at Mothercare plc. He began his career at The Boston Consulting Group, having graduated from the University of Oxford and completed an MBA at INSEAD.

External appointments
Sebastian is Group Chief Executive of Dixons Carphone plc and is also a Trustee of the charities Save the Children and Tablets for Schools.

**7 Andrew Palmer (61),** Non-Executive Director (appointed March 2011) (A, B, I, N, R and +)

Biography
Andrew is Chair of the Audit Committee. He has undertaken a number of senior roles within the financial services and insurance industries. In addition, he has insight into corporate governance developments and best practice in financial reporting through his membership of the Financial Reporting Review Panel of the Financial Reporting Council.

Andrew retired from Legal & General Group plc, where he was the Group Finance Director, in 2009. He is a Fellow of the Institute of Chartered Accountants in England and Wales.

External appointments
Andrew is a Trustee of the Royal School of Needlework, a Trustee and Treasurer of Cancer Research UK and a Non-Executive Director of Royal London Mutual Insurance Society Limited. He is also a member of the Financial Reporting Review Panel of the Financial Reporting Council.

**8 Clare Thompson (60),** Non-Executive Director (appointed September 2012) (A, B, C, I and +)

Biography
Clare is Chair of the Corporate Social Responsibility Committee. She brings with her extensive experience and knowledge gained from roles across the professional services industry, including as Lead Audit Partner at PwC, where she guided companies through change and acted as an adviser to insurance companies. She gained significant experience of both general and life insurance in this role.

Clare was a partner at PwC from 1988 to 2011. During her 23 years as a partner at PwC, she held several senior and high profile roles, particularly within the insurance sector. She is a graduate of the University of York with a degree in Mathematics and is a Fellow of the Institute of Chartered Accountants in England and Wales.

External appointments
Clare is a Non-Executive member of the Partnership Board of Miller Insurance Services LLP and is a Trustee and Treasurer of the Disasters Emergency Committee. She is also a Director of Retail Charity Bonds plc.

**9 Priscilla Vacassin (57),** Non-Executive Director (appointed September 2012) (B, R and +)

Biography
Priscilla is Chair of the Remuneration Committee. She has great knowledge and experience of developing organisational values, and creating the leadership, succession, development and remuneration structures required to support corporate strategy. She has worked both as a practitioner and as an adviser and therefore understands the complexity around remuneration in both technical and market terms.

Priscilla was most recently Group Human Resources Director at Prudential plc and a Non-Executive Director at the Ministry of Defence. Priscilla has previously held senior human resources positions across a number of financial services and customer facing industries, including roles at Abbey National plc, where she was Executive Director, Human Resources; BAA plc, where she was Group Human Resources Director; and Kingfisher plc. She graduated in Law from the University of North East London.

External appointments
Priscilla has her own search and consultancy business.

Key:
(A) Audit Committee
(B) Board Risk Committee
(C) Corporate Social Responsibility Committee
(I) Investment Committee
(N) Nomination Committee
(R) Remuneration Committee
(+) Independent

# Executive Committee

The Executive Committee is chaired by Paul Geddes and, in addition to John Reizenstein, comprises the following individuals:

**1 Jonathan Greenwood,** Managing Director of Commercial (joined 2000)

Experience and qualifications
Jonathan joined the Group in 2000 as Product and Pricing Director for UK partnerships, which included Tesco, BMW and Nationwide Building Society. Following the acquisition of Churchill, Jonathan became Commercial Director and then Managing Director of the Group's household and life businesses. Jonathan was appointed Managing Director of Commercial in 2009.

**2 Mike Holliday-Williams,** Managing Director of Personal Lines (joined May 2014)

Experience and qualifications
Mike was previously Chief Executive Officer of RSA Group's Scandinavian businesses, Codan A/S and Trygg-Hansa. Before joining RSA, Mike worked in the energy, telecoms and retail sectors, beginning his career at WH Smith Limited, before moving to various Centrica-owned businesses, including British Gas and Onetel. He has also served as Managing Director of MORETH>N Limited and holds an EMBA from Ashridge Business School.

**3 Simon Linares,** Human Resources Director (joined September 2014)

Experience and qualifications
Simon was Group HR Director at ITV and before that Human Resources Director of Telefonica's digital businesses globally. Prior to that, Simon was Group Human Resource Director of O2's European businesses, having had previous success in senior HR roles with Diageo.

**4 Steve Maddock,** Managing Director of Claims and Business Services (joined 2010)

Experience and qualifications
Steve was previously Director of Strategic and Technical Claims at RSA, a role he assumed in 2004. He has over 20 years' insurance industry experience, including roles as Director of Claims and Customer Service at Capita and Director of Operations at AMP. Steve holds an MBA from the University of Reading and is Chairman of the Motor Insurers' Bureau.

**5 Angela Morrison,** Chief Information Officer (joined 2010)

Experience and qualifications
Angela was previously Chief Information Officer at J Sainsbury's and a member of their Operating Board. She previously worked for ASDA / Wal-Mart where she held a number of roles including European Strategy Director, Chief Information Officer through the ASDA / Wal-Mart integration and e-Commerce Director which included establishing ASDA's home grocery business. Angela holds a degree in Electrical and Electronic Engineering from the University of Bristol.

**6 Humphrey Tomlinson,** General Counsel (joined 2011)

Experience and qualifications
Humphrey was previously Group Legal Director at RSA. He is a solicitor with over 25 years' experience, including advising on corporate and commercial matters, a wide range of corporate transactions in the UK and internationally, legal risk management and corporate governance issues. Prior to RSA, he worked at City law firm Ashurst Morris Crisp. He is a graduate of the University of Oxford.

**7 José Vazquez,** Chief Risk Officer (joined 2012)

Experience and qualifications
José was previously Global Chief Risk Officer at HSBC Insurance. Prior to joining HSBC, José held senior actuarial roles at Zurich Insurance and also worked as a consultant with KPMG in London. José is a Mathematics graduate from Brunel University and a Fellow of the Institute of Actuaries.

This report details the role and activities of the Board and explains how corporate governance is operated throughout the Group.

## The UK Corporate Governance Code

Direct Line Insurance Group plc (the "**Company**") has complied with the principles and provisions of the UK Corporate Governance Code 2012 (the "**Code**") throughout the year, with the exception of the recommendation contained in Provision E.1.1 of the Code to the effect that the Senior Independent Director (the "**SID**") should attend sufficient meetings with a range of major shareholders. This is to listen to their views to help develop a balanced understanding of the issues and concerns of major shareholders. The Board received regular updates from the Company's corporate brokers on the views of its institutional shareholders. Major shareholders have the opportunity to discuss any issues they wish to raise with the Chairman and the Chair of the Remuneration Committee. Additionally, the Chairman has met certain major shareholders during the year and, through the brokers, offered other major shareholders the opportunity to discuss any matters with him or the SID. The Board is satisfied that, on the basis of reports from the Company's brokers and through the Chairman, it understands the views of the Company's major shareholders.

Details of how the Company applied the Code's principles and complied with its provisions are in this report and the Directors' remuneration report. You can find further information on the Code on the Financial Reporting Council's website at www.frc.org.uk .

## Leadership

### The Board

The Board's primary role is to organise and direct the Group's affairs in a manner that is most likely to promote its long-term success for the benefit of its shareholders as a whole. The Board supervises the Group's operations, ensuring they are effectively managed, that prudent controls are in place, and that risks are assessed and managed appropriately. The Board sets the Group's strategy and monitors management's performance and progress against the strategic aims and objectives.

The specific duties of the Board are set out in the Schedule of Matters Reserved for the Board (the "**Matters Reserved**"). The Matters Reserved are reviewed annually by the Board and contain those items that are specifically reserved for consideration and approval by the Board. Matters requiring approval by the Board include:

- The Group's strategic aims and objectives
- The annual operating and capital expenditure budgets
- Corporate governance matters
- Capital structure, financial reporting and controls, including dividend policy
- The system of internal controls and risk management, including the Group's risk appetite statements
- Major capital projects, major investments and contracts that are either materially strategic or above the Chief Executive Officer's delegated authority
- Board and Committee membership and succession planning
- The remuneration policy for Directors and senior executives
- The 12 Group policies which form part of the high level governance framework

In addition to the Matters Reserved, each Board Committee has written terms of reference defining its role and the authority delegated to it. You can find further details on the Board Committees in the Board Committees' section from pages 61 to 70.

### Board composition

As at the date of this Report, the Board comprises the Chairman, who was independent on his appointment to the Board, the Chief Executive Officer, the Chief Financial Officer and six independent Non-Executive Directors. All of the current Directors served throughout the reporting period, except for Sebastian James, who was appointed to the Board on 28 August 2014.

You can find the names of the Directors as at the date of this report and their biographical information on pages 52 and 53.

Mark Catton, who was nominated by RBS Group as a Non-Executive Director in accordance with the terms of the Relationship Agreement between Direct Line Insurance Group plc and RBS Group, resigned from the Board on 7 March 2014. His resignation followed the sale by RBS Group on 27 February 2014 of its interest in the Ordinary Shares of Direct Line Insurance Group plc. This excluded 4,185,643 shares, which were retained to satisfy long-term incentive plan awards previously granted by RBS Group to certain members of Direct Line Group's management. These shares have since been transferred to an RBS Group Employee Benefit Trust. Since disposing of its shareholding, RBS Group no longer has a right to nominate a director to the Board.

### Structure of the Board

The Board and its Committees have been established to ensure that an appropriate balance of skills, experience, independence, sector knowledge and diversity exists to enable the Directors to discharge their duties and responsibilities effectively.

All Non-Executive Directors must be able to devote sufficient time to the role to discharge their duties and responsibilities effectively. The letters of appointment for the Chairman and each of the Non-Executive Directors set out the anticipated time commitment of at least three days per week for the Chairman and an average of three days per month for the Non-Executive Directors. The Nomination Committee reviews this time commitment annually.

On behalf of the Board, the Nomination Committee assessed the independence, skills, knowledge and experience of the Non-Executive Directors as part of its annual review of each Director's performance. The Board concluded that all of the current Non-Executive Directors were independent, continued to contribute effectively and demonstrated commitment to the role. The Nomination Committee's work in the year resulted in the appointment of Sebastian James as an additional Non-Executive Director. It also resulted in certain changes to the membership of the Committees, which were announced in September 2014. You can find further details of these activities and the Nomination Committee's work in the year on pages 68 to 69.

### Chairman and Chief Executive Officer

The Board has agreed role profiles for the Chairman, Mike Biggs, and the Chief Executive Officer, Paul Geddes, which clearly define their respective roles and responsibilities. This is to ensure no one individual has unfettered powers of decision-making.

The Chairman's priority is leading the Board and ensuring its effectiveness. The Chief Executive Officer's priorities are managing the Group and delivering the Group's strategy and financial results.

### Senior Independent Director

Glyn Jones is the Senior Independent Director ("SID"). His role is to provide a sounding board for the Chairman, to serve as an intermediary for the other Directors when necessary and to be available to shareholders, should they have any concerns they cannot resolve through normal channels. His responsibilities also include evaluating the Chairman's performance annually.

### Non-Executive Directors

The Non-Executive Directors objectively and constructively challenge management. They also use their wider business experience to help develop the Group's strategy.

Non-Executive Directors are initially appointed for a term of three years. They may serve two fixed terms of three years and, in appropriate circumstances, may be invited to serve a further three year term. The Nomination Committee nominates the Directors for appointment. The Board then approves the appointments. Non-Executive Directors are subject to election or re-election annually at the Company's Annual General Meeting ("AGM"). You can find the standard terms and conditions of the appointments at www.directlinegroup.com .

### Information and support

All Directors have access to the assistance and advice of the Company Secretary. The Board is satisfied that it receives information in a timely manner and of an appropriate quality to enable the Directors to discharge their duties. Directors may seek external independent professional advice at the Company's expense if they require it to discharge their duties.

### Conflicts of interest

In accordance with the Companies Act 2006, the Company's Articles of Association allow the Board to authorise a matter in relation to which there is, or may be, a conflict between the Group's interests and the direct or indirect interests of a Director or between the Director's duties to the Group and another person.

Each Director has a duty to avoid conflicts of interest. They must declare any conflict of interest that could interfere with their ability to act in the Group's best interests. The Board has adopted procedures for ensuring its powers to authorise conflicts operate effectively.

The Board has given a number of authorisations in this manner. Notwithstanding such authorisation, the Board continues to ensure that any actual conflict of interest or duty, should it arise, is dealt with appropriately. This would usually involve ensuring the Director does not participate in the relevant Board or Committee discussion or decision.

For this purpose, the Company Secretary maintains a register of conflicts, and of any authorisation of a conflict granted by the Board. The Board reviews this register regularly.

### Board activities during 2014

During 2014, the Board's specific areas of focus, challenge and supervision included:

- Participating in developing and challenging the Group's strategic plan
- Overseeing the prudent management of the Group's capital, ensuring that capital reserves remain robust, while enabling the return of capital to investors by way of special dividends
- Approving and monitoring a comprehensive programme of investment in technology, organisational restructuring and cultural change. This programme aims to improve customer experience, making it easier to do business with the Group, and deliver outstanding customer service
- Overseeing the management and reduction of the Group's cost base
- Overseeing a review and streamlining of the Group's governance framework, including reviewing and approving risk-based policies
- Supporting the Chief Executive Officer in restructuring his management team and appointing new senior executives
- Considering strategic options for the Group's International businesses, and subsequently authorising and monitoring the proposed sale of the Group's International businesses. There was particular emphasis on obtaining fair outcomes for all stakeholders
- Encouraging management initiatives for cultural transformation
- Monitoring the progress of the complex programme of migrating IT systems and telephony from RBS Group to new Direct Line Group platforms, networks and data centres
- Encouraging the relaunch of the Direct Line brand and challenging the related brand and customer-service propositions
- Overseeing the Group's regulatory relationships and preparations for the forthcoming implementation of Solvency II

### Meetings

The Board held 11 scheduled meetings in 2014 and nine additional meetings. The additional meetings were ad hoc or Board sub-committee meetings to consider specific matters, for example, the proposed sale of the Group's International businesses. The Board also held its annual strategy day in June 2014. One of the scheduled Board meetings was held in Glasgow as part of a Board site visit.

The Company Secretary attended all Board meetings. At the Board's discretion, senior executives and external advisers were invited to attend Board meetings and present on business developments and governance issues.

The table below sets out attendance at the scheduled meetings in 2014:

| | Scheduled meetings[1] | Percentage attendance |
|---|---|---|
| **Chairman** | | |
| Mike Biggs | 11 of 11 | 100% |
| **Senior Independent Director** | | |
| Glyn Jones | 11 of 11 | 100% |
| **Non-Executive Directors** | | |
| Mark Catton[2] | 2 of 2 | 100% |
| Jane Hanson | 11 of 11 | 100% |
| Sebastian James[3] | 3 of 4 | 75% |
| Andrew Palmer | 11 of 11 | 100% |
| Clare Thompson | 11 of 11 | 100% |
| Priscilla Vacassin | 11 of 11 | 100% |
| **Executive Directors** | | |
| Paul Geddes | 11 of 11 | 100% |
| John Reizenstein | 10 of 11 | 91% |

### Board induction, resources and training

The Board is committed to training and developing all Directors and employees. The Company Secretary is responsible for helping the Chairman regularly review and organise appropriate training for the Directors and maintains an annual training agenda for the Board and its Committees.

On appointment, Sebastian James commenced a tailored induction programme, comprising 16 sessions. The programme was designed to provide an understanding of the Group's businesses, strategic and transformational priorities, regulatory and governance frameworks, capital and financial management, and risk framework.

The main Board training and development activities in the year under review included the following:

- Training on specific topics, including: competition law, accounting for investments and anti-bribery and corruption
- Visits by Non-Executive Directors to operational business units to meet the management teams and better understand the way the business operates. These included visits to the Claims, Technical and Large Loss, Customer Relations and Counter Fraud teams in Glasgow, and visits to several of the UK Assistance Accident Repair Centres Limited sites
- Internal training workshops on Solvency II, including capital and catastrophe modelling, Internal Model Approval Process ("IMAP") submission requirements, Standard Formula calculation, profit and loss attribution, diversification and dependencies/correlations
- The Company Secretary presented a regular corporate governance update to the Board
- The Group's brokers and financial advisers presented quarterly industry and market updates to the Board
- The Investor Relations team reported regularly to the Board on the Group's relationship with institutional investors and analysts

### Direct Line Group's approach to diversity

The Board carefully considered the diversity of its members from a variety of perspectives. It also sought to ensure that Directors had the relevant range of knowledge, skills, experience and, where necessary, independence to help the Group deliver its strategy.

The Company believes in the merits of diversity. Of the Board's nine members, three are women. However, while the Board will take care to consider diversity when selecting new members, it is committed to appointing the most appropriate candidate.

The Nomination Committee's terms of reference state that due regard to the benefits of diversity, including gender diversity, should be given in selecting candidates for the Board.

The Corporate Social Responsibility Committee also considers this matter in the context of ensuring the Group's talent pipeline remains diverse to meet future requirements. The Group provides mentoring schemes for high-potential candidates and associated training and development programmes. You can find numerical data relating to the gender diversity of the Board, senior managers and employees on pages 34 and 35.

## Board effectiveness review

In 2013, an independent external consultant performed and facilitated the Board's first effectiveness review. In 2014, the Board chose to conduct its effectiveness review in-house. The Company Secretary designed and coordinated the process. This involved agreeing a structured questionnaire with the Chairman and members of the Board, distributing it to stakeholders, collating responses and preparing reports. The Board and each of its Committees reviewed and discussed these reports.

Notes:

1. Attendance is expressed as the number of scheduled meetings attended out of the number of such meetings possible or applicable for the Director to attend.
2. Mark Catton resigned as a Director of the Board on 7 March 2014.
3. Sebastian James was appointed as a Director of the Board on 28 August 2014.

The questionnaire encouraged respondents to comment on aspects perceived as working well in the 2013 review and areas thought to require improvement. Relating to the Board, its Committees and its individual directors, the questionnaire focused on:

- The flow of information, including the quality and sufficiency of reports, management information and training
- The behaviour of, and interaction between, the Board or Committee and management, including the proportion of time spent on strategic matters, the degree of challenge by Non-Executive Directors, the Board's culture and composition
- Administration, including the number and frequency of meetings, the volume of papers, the quality of systems and processes for, Board and Committee support

The Chairman discussed the outcome of the effectiveness review with the Non-Executive Directors and the Chief Executive Officer, providing them with feedback on their performance and contributions. Feedback on the Chairman's performance was provided by the Senior Independent Director, with input from his fellow Non-Executive Directors.

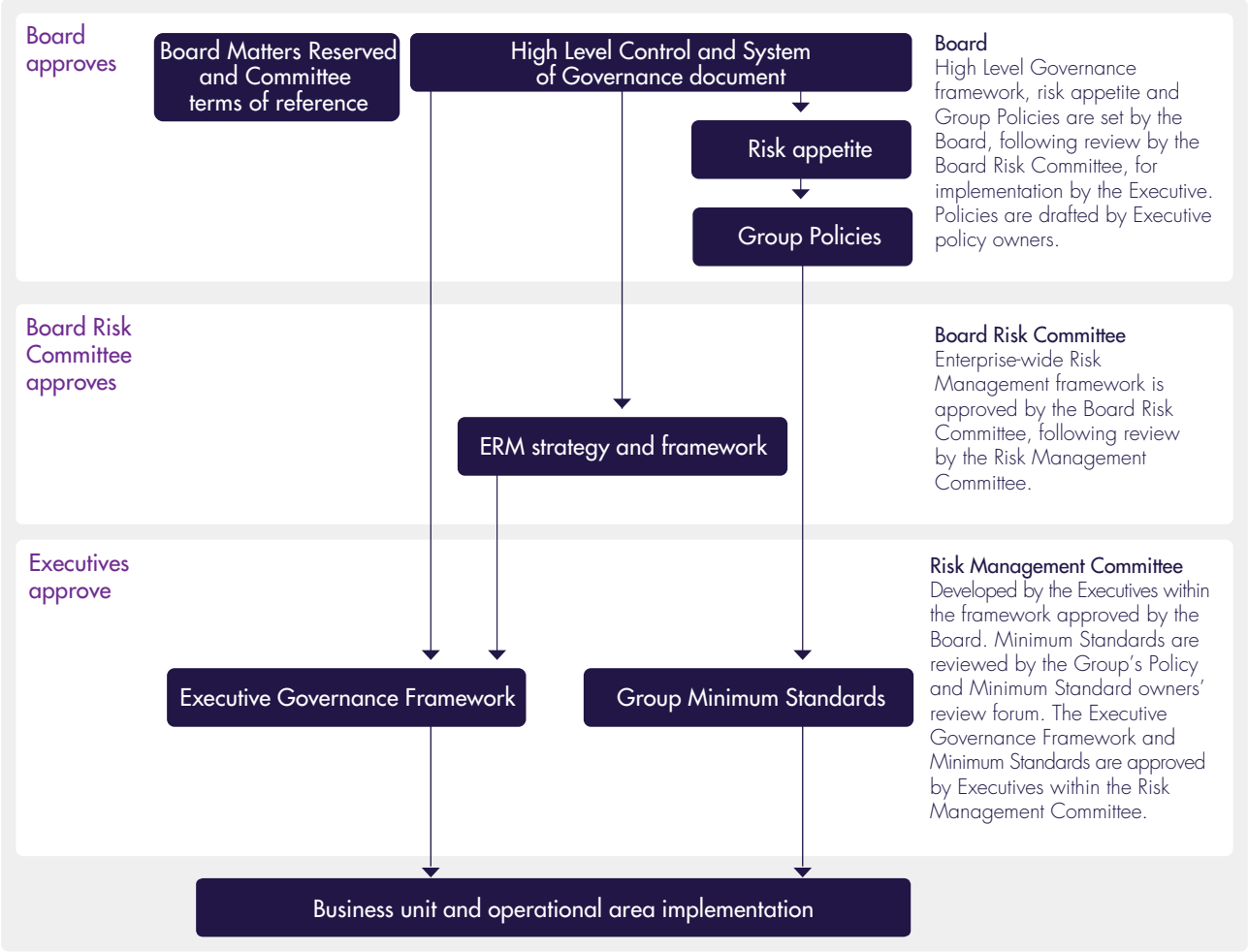
Based on responses to the structured questionnaire and the resulting reports, the Directors are satisfied that the Board and its Committees operated effectively during 2014. The Directors are also satisfied that significant progress was made regarding areas identified in 2013 as requiring improvement. The Board and its Committees agreed an action plan for further improvement, which will be pursued in 2015.

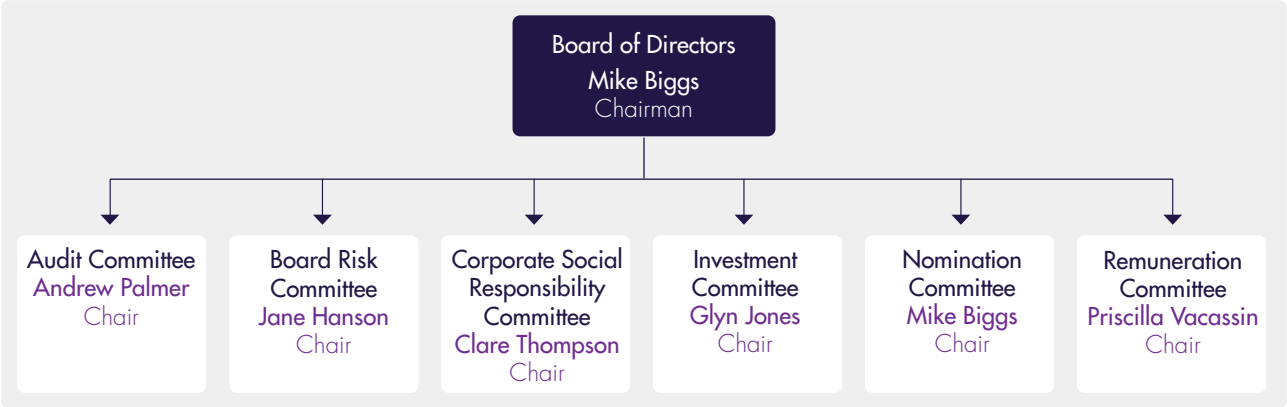
## Governance framework and structure

The Board is responsible for ensuring an appropriate system of governance is in place throughout the Group. This includes a robust system of internal controls and a sound Risk Management framework. The Group's Governance Framework is detailed in the High Level Control and System of Governance document. The Board reviews this document annually. In addition to this document, the core elements are:

- The Enterprise-wide Risk Management ("**ERM**") strategy and framework, which sets out the Group's robust risk management approach and the ownership and oversight of risks
- The Executive Governance Framework, which outlines how each business function is governed and details the delegation of authority to Executive Committee members
- The Group Policy Framework, which comprises a set of policies that are required to be approved by the Board and are underpinned by Minimum Standards which translate the policies into requirements that are implemented throughout the Group

The diagram below summarises the split of responsibilities for the different components of the Group's Governance Framework.






### Board Committees

The Board has established a number of Committees to help meet its responsibilities. Each Committee plays a vital role in ensuring the Board operates efficiently and considers matters appropriately. The diagram above details the names of the Board Committees and the Chairs.

Each Board Committee has separate terms of reference. The Board reviews these annually. You can find details of the composition, attendance, role and focus of each Committee on pages 61 to 70.

### Chief Executive Officer

Although the Board is ultimately responsible for the success of the Company, Paul Geddes, the Chief Executive Officer, has received delegated authority from the Board to manage the day-to-day operations of the Group and deliver its strategic objectives.

In turn, Paul Geddes has cascaded certain elements of his delegated authority to the members of the Executive Committee. These delegations help ensure that senior executives are accountable and responsible for managing their respective businesses and functions. The delegations also involve ensuring the senior executives have the appropriate financial, and other, authorities needed to manage those business areas.

### Executive Committee

The Executive Committee is the principal management committee that assists the Chief Executive Officer in the day-to-day management of the Group. It supports him in setting performance targets, implementing the Group's strategy and direction as determined by the Board, and monitoring key objectives and commercial plans to help achieve the Group's targets. It also helps him evaluate new business initiatives and opportunities, and receives and considers reports on operational matters, where these are material to the Group or have cross-company implications.

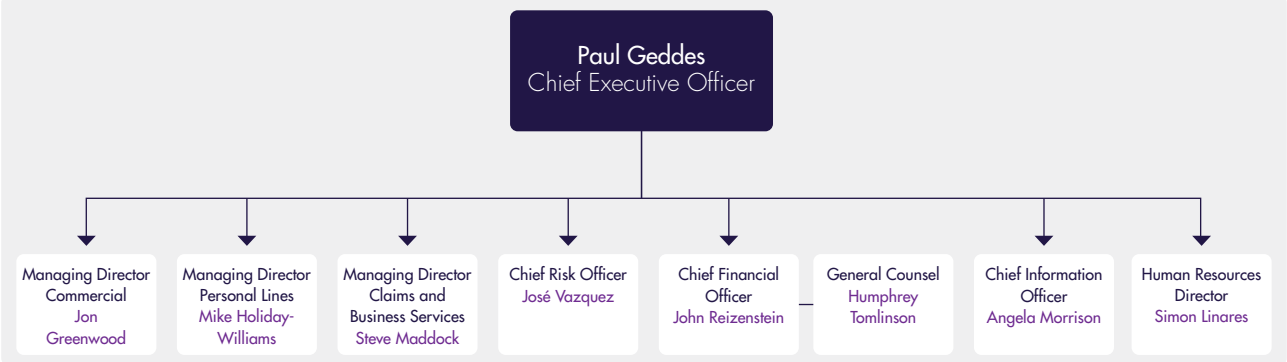
The diagram below depicts the management-governance framework.

## Accountability

### Financial and business reporting

The Board is responsible for providing shareholders with a fair, balanced and understandable assessment of the Company's position and prospects. The Board is also responsible for the maintenance of adequate accounting records and ensuring compliance with statutory and regulatory obligations.

An explanation from the Directors of their responsibility for preparing the financial statements is set out in the statement of Directors' responsibilities on page 97. The statement by the Company's external Auditor explaining their responsibilities is on page 102.



The Board meets the specific responsibilities that the Code places on it as follows:

- An explanation of how the Company generates value over the long term is included within the business model on page 8 and the strategy for delivering Company objectives on page 16
- How the Board has concluded that the business remains a going concern is discussed on page 96
- The arrangements established by the Board for the application of risk management and internal control principles are detailed below
- The Board has delegated oversight of the management of the relationship with the Company's external Auditor to the Audit Committee. The Audit Committee report on pages 61 to 63 provides details of its role, activities and relationship with the internal and external Auditors

### Risk management and internal control system

The Board oversees the Group's risk management and internal control system. It has complied with the Code by establishing a continuous process for identifying, evaluating and managing the significant risks the Group faces. This process includes risks arising from social, environmental and ethical matters.

The Group operates a 'three lines of defence model', further details of which can be found in the Risk Management section on pages 28 to 31.

During the year, the Board reviewed the effectiveness of the Group's risk management and internal controls. The Group's assessment process included output from a system for reporting on all significant risks that stand in the way of the Group's objectives. The system reported on the nature and effectiveness of the controls and other management processes that manage these risks. The system also sets risk appetites for key categories of quantifiable risk. Additionally, it encompassed risk owners' self-assessment of control throughout the Group. The second and third lines of defence independently challenge their assertions. Furthermore, Group Audit has undertaken reviews in the financial year to support this.

The Board Risk Committee regularly reviews significant risks, their potential impact on the Group's financial position, variations from agreed risk appetites, and the actions taken to manage those risks.

### Internal systems of control

The Board has established a management structure with defined lines of responsibility and clear delegation of authority. This control framework cascades through the divisions and central functions, detailing clear responsibilities for ensuring appropriate controls are in place at an operational level. This includes controls relating to the financial reporting process.

The Group Audit function supports the Board by providing an independent and objective assurance of the adequacy and effectiveness of the Group's operations. It brings a systematic and disciplined approach to evaluating and improving the effectiveness of its risk management, control and governance frameworks and processes.

The Directors know that any system of internal control is designed to manage, not eliminate, the risk of failing to achieve business objectives. It can only provide reasonable, not absolute, assurance against material misstatement or financial loss.

On behalf of the Board, the Audit Committee regularly reviews the effectiveness of the Group's internal control systems. Its monitoring covers all material controls. Principally, it reviews and challenges reports from management, the Group Audit function and external Auditors. This enables it to consider how to manage or mitigate risk in line with the Group's risk strategy. The Committee did not identify or report any major failings or weaknesses to the Board in 2014.

## Remuneration

The Board has delegated to the Remuneration Committee responsibility for the remuneration arrangements of the Group's Executive Directors and for overseeing senior executives' remuneration. Find out more information on the remuneration arrangements and policy in the Directors' remuneration report on page 71.

## Relations with shareholders

The Board believes that actively engaging with the Company's shareholders is fundamental to the Group's business. An active dialogue and ongoing engagement with investors is vital to keeping up-to-date on opinions. It also provides the Company with the opportunity to address any questions and concerns proactively.

The Executive Directors meet frequently with investors and ensure shareholder concerns are communicated to the Board. The Chairman, Senior Independent Director and Non-Executive Directors are available to attend meetings with major shareholders at their request. This gives the Directors the opportunity to discuss governance and strategy with shareholders.

The Company's Investor Relations team facilitates the Directors' ongoing dialogue with institutional investors, fund managers and analysts. The Board receives regular updates on investor relations, including feedback from analysts. The Company's corporate brokers also regularly attend Board meetings to inform the Board of shareholder views.

### Annual General Meeting

The Board views the Company's AGM as a good opportunity for private shareholders to communicate directly with the Board. All shareholders are entitled to attend the AGM. All Directors attended the AGM in 2014.

The Chief Executive Officer presents the Group's results before the Chairman proposes the AGM's formal business. All shareholders are encouraged to ask questions relating to the meeting's business. The Chairman, the Committee Chairs and the remaining Directors are also available at the meeting.

# Audit Committee report

**Andrew Palmer,**
Chair of the Audit Committee

## Role of the Audit Committee

The Committee is responsible for overseeing and challenging the effectiveness of the Group's systems of financial control, financial and regulatory reporting and other internal controls. The Committee reviews the adequacy and integrity of the Group's internal financial controls and internal control systems, and the procedures for monitoring their effectiveness. It also monitors the work and effectiveness of the Group's internal and external auditors and actuaries.

The Committee has unrestricted access to management and external advisers to help discharge its duties. It is satisfied that, during 2014, it received sufficient, reliable and timely information to perform its responsibilities effectively.

You can find the Audit Committee's terms of reference at www.directlinegroup.com .

## Committee composition, skills and experience

The Committee comprises four independent Non-Executive Directors: Andrew Palmer; Jane Hanson; Glyn Jones; and Clare Thompson. You can find the members' biographical information on pages 52 to 53.

All Committee members are members of the Institute of Chartered Accountants in England and Wales. They also have recent and relevant financial experience, enabling them to contribute diverse expertise to the Committee's proceedings. To keep skills current and relevant, members of the Committee have received training by Deloitte LLP focused on Solvency II and trends in the motor insurance market, in addition to training available to the whole Board.

### Audit Committee focus during 2014

- Assessed and monitored the risks associated with migrating the Group's finance systems from RBS Group to the Group's new IT platform
- Reviewed the Group Audit function's performance and effectiveness, including commissioning an external quality assessment of the function
- Reviewed the Group-wide Financial Reporting Control Framework
- Adopted and monitored the Group's policy and minimum standard for the Independence of External Audit
- Reviewed the impact of selling the International division on the financial statements
- Reviewed financial results announcements, including the 2013 Annual Report & Accounts, the 2014 Half Year Interim Report, and Interim Management Statements
- Assessed the disclosures in the 2013 Annual Report & Accounts to provide advice to the Board on whether the report, taken as a whole, was fair, balanced and understandable and provided the information necessary for shareholders to assess the Company's performance, business model and strategy
- Reviewed reports and received training for Solvency II
- Assessed the going concern status of the Company and its principal operating subsidiary, U K Insurance Limited
- Reviewed the effectiveness of internal control processes
- Approved the Group Audit plan and reviewed Group Audit reports on key control issues
- Reviewed the results of the external audit relating to the 2013 year end and approved the scope of the external audit regarding the 2014 year end
- Reviewed the external Auditor's independence and objectivity
- Determined the external Auditor's remuneration and recommended it to the Board
- Considered the Group's policy on tendering its independent external audit contract against the backdrop of regulatory and best practice developments
- Recommended the reappointment of the external Auditor to the Board, for approval by shareholders at the 2014 Annual General Meeting
- Reviewed reserving governance and processes, and considered quarterly actuarial and proposed management best estimates of technical reserves
- Considered an external peer review of reserves
- Considered regulatory developments and their impact on assumptions and judgements used in the Group's reserving and reporting
- Reviewed critical accounting estimates and judgements, including outstanding claims provisions and related reinsurance recoveries, impairment provisions on financial assets, fair value of properties, deferred acquisition costs and goodwill

## Meetings

The Audit Committee held five scheduled meetings in 2014, at appropriate times in the financial and regulatory reporting and audit cycle. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings | Percentage attendance |
|---|---|---|
| Andrew Palmer (Chair) | 5 of 5 | 100% |
| Jane Hanson | 5 of 5 | 100% |
| Glyn Jones | 5 of 5 | 100% |
| Clare Thompson | 5 of 5 | 100% |

Sub-committees of the Audit Committee met in May and October 2014 to approve the Group's Interim Management Statements relating to the first and third quarters of the 2014 financial year. The quorum of both sub-committee meetings comprised Andrew Palmer, Paul Geddes and John Reizenstein.

The Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Group Financial Controller and Head of External Reporting are invited to attend Audit Committee meetings. The Actuarial Director, external actuarial advisers, external Auditor and Group Head of Audit are also invited to attend meetings and meet privately with the Audit Committee, in the absence of management. The Managing Director of Claims and Business Services is also invited to attend appropriate sections of Audit Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

## Internal control and Group Audit

During the year, the Audit Committee reviewed the adequacy and effectiveness of the Group's internal control systems.

The Group's Financial Reporting Control Framework ("**FRCF**") forms part of its wider internal controls system. It is based on the principles of the Committee of Sponsoring Organisations of the Treadway Commission's Enterprise Risk Management Framework and is designed to address risks relating to financial reporting. The Board's supervision of the FRCF is delegated to the Audit Committee. Daily responsibility for the FRCF is delegated to the Chief Financial Officer.

During 2014, management reviewed and tested the FRCF's design and effectiveness. The Committee received reports focusing on control deficiencies, and mitigating and remedial action taken. The Committee also assessed and monitored the risks associated with migrating the Group's finance systems from RBS Group to the Group's new IT platform.

The Audit Committee oversees the work of Group Audit and ensures Group Audit appropriately adopts industry best practice. The Group Head of Audit reports functionally to the Chair of the Committee and has a secondary reporting line to the Chief Financial Officer for management purposes. At each of its meetings, Group Audit provides the Committee with independent and objective reports on the appropriateness and effectiveness of the Group's internal controls and governance frameworks. The Committee approves Group Audit's annual plan, and receives quarterly reports detailing internal audit activity, key findings, management responses and proposed action plans. The Group Audit function monitors completion of these actions.

During 2014, and following a formal tender-evaluation process, the Committee appointed Deloitte LLP to conduct an external quality assessment of Group Audit in accordance with the guidelines of the Chartered Institute of Internal Auditors ("**CIIA**"). The assessment included evaluating the effectiveness of Group Audit, with reference to CIIA's Standards and Code of Ethics and its recommendations for Effective Internal Audit in the Financial Services Sector. A benchmark against comparable industry peers was also performed. Deloitte LLP submitted the resulting report to the Committee, which concluded that Group Audit is performing effectively. The Committee endorsed recommendations for continuing improvement and was satisfied that Group Audit has access to appropriate resources.

The Committee considered the Group's internal controls and processes for identifying and responding to the risk of fraud.

## Reserves

The Committee approves annual plans for reviews of reserves, informed by emerging internal and external issues. It also considers an appropriate balance between internal and external actuarial review. Consultants appointed to provide actuarial reviews of reserves are subject to approval by the Committee. The external actuarial review was carried out by PricewaterhouseCoopers LLP for Direct Line Insurance Group plc and its relevant affiliates[1] only and not for anyone else.

Every quarter, the Committee reviews and challenges the key assumptions and judgements, emerging trends, movements and analysis of uncertainties underlying the actuarial best estimate of technical provisions. At the same time, the Committee considers and challenges the appropriateness of the Chief Financial Officer's proposals for the management best estimate of reserves. These are informed by actuarial analysis, wider commercial and risk-management insights, and principles of consistency from period to period.

After reviewing the actuarial best estimate and management best estimate of reserves, the Committee recommends them to the Board.

## Financial reporting

During the year, the Committee reviewed the preliminary announcement of the Group's 2013 results, the 2013 Annual Report & Accounts, and the 2014 Half Year Interim Report. The Committee then recommended them to the Board for approval.

The review process focused on critical accounting policies and practices, emphasising those requiring a major element of judgement. The review also considered going concern assumptions, impairment reviews, reserving provisions, unusual transactions, clarity of disclosures and significant audit adjustments.

The Committee also advised the Board whether the financial statements, taken as a whole, were fair, balanced and understandable and provided sufficient information to enable the reader to assess the Group's performance, business model and strategy.

Note:

1. The relevant affiliates are U K Insurance Limited and Churchill Insurance Company Limited.

In addition to matters relating to reserving, issues and judgements considered by the Committee included:

- Provisions, including the release of an onerous lease provision after purchasing a property and recognising a subsequent impairment charge
- The carrying values of goodwill and other intangible assets, and the need for any impairment provisions
- Classifying investment properties for fair-value disclosure purposes
- The carrying value of the Group's financial investments and the need for any impairment provisions
- Judgements regarding tax, particularly the carrying value of any deferred tax assets and liabilities
- The sale of the International division
- Reinsurance recoverables

The Committee also reviewed and delegated authority to a sub-committee to approve the quarterly Interim Management Statements.

## External Audit

Deloitte LLP has served as the Company's Auditor since 2000. Before listing, the Group was audited as a division of RBS Group. In accordance with the Group's policy on maintaining the independence of external audit, Deloitte LLP must ensure that the audit partner engaged on the audit is rotated regularly and the current partner is scheduled to be rotated after the 2015 year end.

Under the transitional rules for audit tendering and auditor rotation, as set out in the Competition and Markets Authority's Order and the EU Audit Regulation, Deloitte LLP cannot be reappointed as Auditor of the Company after June 2023. The Committee has decided it will consider the timing of a tender before that date during 2015, to align with the current audit partner's rotation and taking the Group's strategic priorities into account. In addition under the Order, the Committee will be responsible for negotiating the audit fee and setting the scope of the audit.

There are no contractual obligations restricting the Company's choice of external Auditor and no auditor liability agreement has been entered into. Equally, any recommendation to reappoint Deloitte LLP as Auditor of the Company depends on continued satisfactory performance.

## Auditor independence and non-audit services policy

The Group has adopted an Independence of External Audit minimum standard which established parameters for preventing or mitigating any compromise of the external Auditor's independence or objectivity by virtue of their providing non-audit services to the Group.

In accordance with the Independence of External Audit minimum standard, the Committee formally approves a list of audit and non-audit services to be provided by the external Auditor before each financial year.

Authority has been delegated to the Chair of the Audit Committee to approve any non-audit services costing up to £100,000. Non-audit services with a value exceeding £100,000 require the Committee's approval. The Committee receives and reviews a report on all consultancy spend, including non-audit services, at least twice a year.

During the year, the Committee approved fees payable to Deloitte LLP for services not related to audit work of £0.4 million. These fees related to audit assurance and tax services. The following is a breakdown of fees paid to Deloitte LLP in respect of the year ended 31 December 2014.

| | Fees £m | Proportion |
|---|---|---|
| Audit fees[1] | 2.3 | 85.2% |
| Non-audit fees | 0.4 | 14.8% |
| **Total fees for audit and other services** | **2.7** | |

Having reviewed the application of the Group's minimum standard on audit and non-audit services during 2014, the Committee is satisfied that adequate procedures are in place to safeguard the external Auditor's independence and objectivity.

## Effectiveness of the external audit process and the re-appointment of the external Auditors

During 2014, in addition to regular questioning of the Auditor during its meetings, the Audit Committee assessed the effectiveness of the external Auditor. It achieved this through a detailed questionnaire completed by key stakeholders, discussions with the Chief Financial Officer, a formal review of Deloitte LLP's independence, and an assessment of its fulfilment of the agreed audit plan.

The Committee concluded that Deloitte LLP had effectively and appropriately performed its obligations as external Auditor to the Group. Following this review, the Audit Committee has recommended to the Board that Deloitte LLP be reappointed as external Auditor to the Group. A resolution to this effect will be put to the shareholders at the 2015 AGM.

## Effectiveness of the Audit Committee

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

The Board reviewed and approved this report on 2 March 2015.

**Andrew Palmer,** Chair of the Audit Committee

Note:

1. Includes the audit fee for discontinued operations, the Group's International division. Further information can be found in note 11 to the consolidated financial statements.

# Board Risk Committee report

**Jane Hanson,**
Chair of the Board Risk Committee

## Role of the Board Risk Committee

The Committee is responsible for providing oversight and advice to the Board in relation to the Group's current and potential future risk exposures and the strategic approach to managing risk. The Committee recommends risk appetite and tolerance levels to the Board, and promotes a risk-awareness culture within the Group.

The Committee has unrestricted access to management and external advisers to help discharge its duties. It is satisfied that during 2014, it received sufficient, reliable and timely information to perform its responsibilities effectively. During the year, at the Committee's request, external consultants undertook specific reviews. These included validation activities regarding the IMAP submission.

You can find the Board Risk Committee's terms of reference at www.directlinegroup.com .

## Committee composition, skills and experience

The Committee comprises four independent Non-Executive Directors: Jane Hanson; Andrew Palmer; Clare Thompson; and Priscilla Vacassin. You can find the members' biographical information on pages 52 to 53.

## Meetings

The Board Risk Committee held six scheduled meetings in 2014, one of which was a joint meeting with the Remuneration Committee. Additionally, four sub-committee meetings were held to consider Solvency II and IMAP matters. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings | Percentage attendance |
|---|---|---|
| Jane Hanson (Chair) | 6 of 6 | 100% |
| Andrew Palmer | 6 of 6 | 100% |
| Clare Thompson | 6 of 6 | 100% |
| Priscilla Vacassin | 5 of 6 | 83% |

The Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Group Head of Audit, General Counsel and a representative from the External Auditor are invited to attend Board Risk Committee meetings. In addition to regular one-to-one meetings with the Chair, the Chief Risk Officer also met privately with the Committee, in the absence of management.

The Director of Compliance and Regulatory Risk, Director of Financial Risk, Enterprise Risk Director, and Head of Investigations and Anti-Bribery are also invited to attend appropriate sections of the Board Risk Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

### Board Risk Committee focus during 2014

- Assessed and monitored the Risk function's oversight of major change initiatives. These included IT migration and transformation programmes
- Reviewed and challenged the Solvency II programme plan and timetable, and received reports and training on various Solvency II matters. These included: the IMAP plan; outputs of external validation and assurance activities; the strengths and limitations of the Internal Economic Capital Model; and dependencies, correlations and diversification
- Reviewed the stress testing and scenario analysis plan for 2014, and the outputs of two specific reverse stress tests undertaken at the Committee's request
- Commissioned an external review of the Financial Promotions team and considered the findings and recommendations
- Reviewed the findings and output of a review undertaken by an external consultant regarding the maturity of the Risk Management Committee
- Reviewed the strategic approach to managing risk across the Group and monitored the effectiveness of the ERM framework
- Approved the Risk and Compliance plan and Conduct and Compliance assurance plan, and assessed the level and effectiveness of resource within the Risk function
- Recommended approving the Group's risk appetite and risk policies to the Board
- Reviewed and challenged the Group's conduct risk and compliance management processes to drive the right customer outcomes. The Committee regularly reviewed and challenged key risk indicators and measures covering the key areas of treating customers fairly and core regulatory interactions
- Reviewed the adequacy of the Group's arrangements to allow employees to raise concerns and reviewed reports on these matters. Assessed the effectiveness of the Group's anti-money laundering and sanctions systems and controls
- Worked with the Remuneration Committee to ensure risk management is considered and included when assessing the performance of senior executives, and incorporated into the incentive schemes for customer facing roles and for technicians and support staff in the accident and repair centres
- Reviewed the ORSA report for 2014

## Major change programmes

The Committee received regular reports on the major change programmes undertaken in the Group. During the year, the Committee commissioned several reviews, including a detailed risk assessment by an external consultant of the transformation programme to expand the Group's capabilities, develop new technology and digital tools to support customers, focusing on governance and programme setup. The reviews culminated in detailed presentations at scheduled Committee meetings, where the findings were reviewed and actions agreed.

## Solvency II

During 2014, the Group continued progressing towards compliance with Solvency II requirements; the Solvency II Directive has an implementation date of 1 January 2016. The Committee has considered a range of Solvency II matters at scheduled meetings and training sessions. Key areas of focus have included: the approach to IMAP validation and the IMAP submission process; Internal Economic Capital Model developments, strengths and limitations; profit and loss attribution; and dependencies, correlations and diversification.

## Stress and scenario testing

Regular stress testing and scenario analysis, including reverse stress testing, is a core component of the Group's ERM framework. It supports the Group's strategic objectives and is an area of increasing focus for the PRA. During the year, the Committee requested that the Risk function undertake two reverse stress tests: the impact of multiple weather events; and the mis-selling of customer policies. The Committee reviewed and challenged the outputs of these reverse stress tests, and considered the proposed management actions.

## Risk management framework

During 2014, the Committee reviewed and approved several enhancements to the ERM framework. These included the re-launched Group Policies and Minimum Standards, and an enhanced Emerging Risks Register, which provides a forward-looking perspective on emerging risks facing the organisation. The Committee also reviewed and challenged the ORSA in advance of Solvency II. The Committee provided oversight of risk management operations by reviewing the Risk and Compliance operational plan. These included the Group's approach to conduct and culture; reviewing and approving the Group's Risk Appetite Statements and Material Risk Register; and considering the effectiveness of the ERM framework.

## Risk appetite monitoring

The Committee received regular reports corresponding to the three strategic risk objective appetite statements: maintain capital adequacy; stable/efficient access to funding and liquidity; and maintain stakeholder confidence, together with lower level risk appetite statements that supported these. The Committee monitored the Group's exposure against these appetites, and assessed the drivers impacting the risk appetite status.

## Conduct and compliance risk

As part of the Chief Risk Officer's report, the Committee reviewed and challenged the conduct and compliance risk measures, covering customer and regulatory interactions across the Group's functions, with a particular emphasis on achieving the right customer outcomes. The Committee commissioned an external review of the Financial Promotions team, focusing on governance of approval processes and systems and controls. Additionally, the Committee ensured that there is a standing agenda item on Compliance and Regulatory Risk, including conduct risk, with updates on any key developments at each scheduled Committee meeting from the Group's Director of Compliance and Regulatory Risk.

## Whistleblowing and financial crime

The Committee received regular updates on the Company's whistleblowing process. It also reviewed the arrangements for employees to report any concerns about suspected illegal or unethical behaviour within Direct Line Group, without fear of adverse consequences. The Committee received annual reports from the Money Laundering Reporting Officer, who has delegated authority from the Board to ensure that the Group has appropriate systems and controls in place to manage money laundering and sanction risks; and the UK designated Anti-Bribery and Corruption Officer.

## Remuneration

During the year, the Board Risk and Remuneration Committees held a joint meeting to ensure risk management metrics are considered as part of evaluating the performance of senior executives, and are incorporated into the incentive schemes for customer facing roles in the insurance sales and service contact centres, and for technicians and support staff within the UK Assistance Accident and Repair Centres. The Committees considered matters including regulatory developments in remuneration and the level of preparedness in relation to the draft Solvency II guidance; and how the performance of individuals in Control Functions should be assessed.

## Effectiveness of the Board Risk Committee

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

The Board reviewed and approved this report on 2 March 2015.

**Jane Hanson,** Chair of the Board Risk Committee

# Corporate Social Responsibility Committee report

**Clare Thompson,**
Chair of the Corporate Social Responsibility Committee

## Role of the Corporate Social Responsibility Committee

The Corporate Social Responsibility ("**CSR**") Committee provides oversight and advice in relation to how the Group conducts its business responsibly, including in relation to health and safety, the environment, employee engagement and wellbeing, community involvement and ethical matters. The Committee considers the role of the Group in society, including environment and community engagement policies.

## Committee composition

The Committee comprises three independent Non-Executive Directors: Jane Hanson; Sebastian James; and Clare Thompson; together with Paul Geddes, Chief Executive Officer; and Angela Morrison, Chief Information Officer. You can find the members' biographical information on pages 52 to 54.

During the year, Clare Thompson became Chair of the CSR Committee. Jane Hanson retired as Chair at that time but continues to be a member. The Board also approved the appointment of Angela Morrison as a member of the Committee, following Tom Woolgrove's departure from the Group, and the appointment of Sebastian James as an additional Committee member.

## Meetings

The CSR Committee held four scheduled meetings in 2014. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings | Percentage attendance |
|---|---|---|
| Clare Thompson (Chair) | 4 of 4 | 100% |
| Paul Geddes | 3 of 4 | 75% |
| Jane Hanson | 4 of 4 | 100% |
| Sebastian James[1] | 1 of 1 | 100% |
| Angela Morrison[1] | 3 of 3 | 100% |
| Tom Woolgrove[1] | 2 of 2 | 100% |

The Human Resources Director, Managing Director of Claims and Business Services, Head of Public Affairs and Sustainability, Head of Employee Relations and Engagement and CSR Manager are invited to attend CSR Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

### CSR Committee focus during 2014

- Reviewed and approved the Group's CSR 2015 strategy and four key focus areas
- Reviewed and approved the adoption of a CSR Charter
- Received regular reports from the Diversity Network Alliance group, focusing on the gender, working families and diversity strands
- Held a scheduled Committee meeting in the Glasgow office, following an informal lunch with colleagues representing the Glasgow Local Community Team, and the Charity and Social Committee
- Reviewed updates on emerging CSR matters, including presentations from external speakers
- Received regular reports from the Health and Safety Committee, and assessed health and safety performance against the previously agreed plan
- Reviewed progress against the Group's sustainability targets, which are published on our website
- Received updates on employee engagement in relation to CSR matters, volunteering and community activities

## CSR 2015 strategy

The Committee reviewed and approved the Group's CSR 2015 strategy. It incorporates an overarching principle that a clear benefit to the Group's business, customers and people must be embedded in the CSR strategy and every focus area. The four focus areas, each sponsored by a member of the Executive Committee, are as follows:

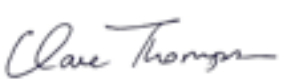
- Helping to make our society safer – Mike Holliday-Williams
- Proud to be here – Simon Linares
- Reduce, Reuse and Recycle – Steve Maddock
- Being recognised as part of our communities – Jon Greenwood

You can find more information on the Group's approach and priorities regarding CSR in the CSR report on pages 32 to 35.

## Effectiveness of the CSR Committee

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

The Board reviewed and approved this report on 2 March 2015.



**Clare Thompson,** Chair of the CSR Committee

Note:

1. Attendance is expressed as the number of scheduled meetings attended out of the number of such meetings possible or applicable to attend.

# Investment Committee report

**Glyn Jones,**
Chair of the Investment Committee

## Role of the Investment Committee

The Committee is responsible for overseeing the development of the Group's investment strategy and the management and performance of the Group's investment portfolio.

## Committee composition, skills and experience

The Committee comprises four independent Non-Executive Directors: Glyn Jones; Jane Hanson; Andrew Palmer; and Clare Thompson. You can find the members' biographical information on pages 52 to 53.

## Meetings

The Investment Committee held four scheduled meetings in 2014. Additionally, one meeting was called to consider a new investment allocation. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings | Percentage attendance |
|---|---|---|
| Glyn Jones (Chair) | 4 of 4 | 100% |
| Jane Hanson | 4 of 4 | 100% |
| Andrew Palmer | 3 of 4 | 75% |
| Clare Thompson | 4 of 4 | 100% |

The Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Director of Investment Management and Treasury, and Director of Financial Risk are invited to attend Investment Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

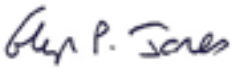
## Effectiveness of the Investment Committee

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

### Investment Committee focus during 2014

- Considered proposals to develop further the Group's investment strategy. This resulted in the following recommendations (with attendant capital implications) being made to the Board, which approved them:
  - An allocation to UK infrastructure debt, to include as part of the asset strategy backing Periodical Payment Order ("PPO") liabilities
  - An investment into US Dollar short-duration high yield debt to enhance future expected returns from the portfolio
  - An allocation to Pound Sterling private placement bonds to enhance expected returns and provide further issuer diversification for the portfolio
- Monitored global macroeconomic developments and financial market yields, and considered the likely impact and risks for budgeted investment returns in 2014 and the Group's capital base
- Requested a study of investment strategies to help identify any attractive investment opportunities (appropriate for an insurer) not presently accessed by the Group
- Examined how the Group was enhancing expected returns from cash/near cash assets by using more widely liquidity products available in the market and investigated the Group's ability to obtain full visibility of underlying assets and to understand the capital implications of investing in such products
- Considered reports from the Director of Investment Management and Treasury covering matters including: key market developments; financial performance from investment activity; performance of internally managed portfolios, external fund managers and the custodian; and compliance with agreed risk and exposure limits
- Considered the findings from a report prepared by the Group Audit function. This report examined the effectiveness of key processes within the Investment and Treasury department
- Examined proposals regarding enhancing the key risk indicator framework used to monitor investment activities and requested a better understanding of the rationale and governance underpinning the calculation and setting of Value at Risk limits employed by the Group
- Requested periodic updates from management regarding planning and delivery of regulatory-driven changes impacting investments (notably European Market Infrastructure Regulation derivative reporting (delivered in 2014) and the future requirement for Solvency II reporting of assets)

The Board reviewed and approved this report on 2 March 2015.



**Glyn Jones,** Chair of the Investment Committee

# Nomination Committee report

**Mike Biggs,**
Chair of the Nomination Committee

## Role of the Nomination Committee

The Committee is responsible for keeping the Board's structure, size, composition, and balance of skills, experience and expertise under review. The Committee recommends Board and Committee appointments to the Board, reviews the Group's leadership needs, and monitors the Executive and Non-Executive Director succession plans. It also reviews Directors' time commitment and considers and recommends the re-election of Directors at the Company's AGM.

You can find the Nomination Committee's terms of reference at www.directlinegroup.com .

## Committee composition, skills and experience

The Committee comprises the Chairman, Mike Biggs, and two independent Non-Executive Directors: Glyn Jones; and Andrew Palmer. You can find the members' biographical information on pages 52 to 53.

## Meetings

The Nomination Committee held three scheduled meetings in 2014. Additionally, three meetings were held to deal with matters emerging during the year. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings | Percentage attendance |
|---|---|---|
| Mike Biggs (Chair) | 3 of 3 | 100% |
| Glyn Jones | 3 of 3 | 100% |
| Andrew Palmer | 3 of 3 | 100% |

The Chief Executive Officer is invited to attend Nomination Committee meetings. The Chair of the Remuneration Committee, Human Resources Director and General Counsel are also invited to attend appropriate sections of the Nomination Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

### Nomination Committee focus during 2014

- Evaluated the Board's balance of skills, knowledge, experience and diversity
- Considered the requirement for an additional Non-Executive Director, defined search criteria, engaged JCA Group Limited ("**JCA Group**") as external search consultants, assessed potential candidates, and recommended appointing Sebastian James to the Board
- Reviewed the Group's leadership needs and considered succession planning for Executive and Non-Executive Directors, and senior executives
- Reviewed the membership and chairmanship of Board Committees, and recommended appropriate changes
- Reviewed the letters of appointment and appointment terms for Non-Executive Directors
- Reviewed the independence and time commitment of Directors, and recommended their re-election at the 2014 AGM

## Changes to the Board

Mark Catton, who had been nominated to represent RBS Group on the Board, stepped down on 7 March 2014. This followed RBS Group selling substantially all of its shareholding in the Company in February 2014. Sebastian James was appointed as a Non-Executive Director of the Company on 28 August 2014.

## Board appointment and reappointment process

During 2014, the Committee oversaw the appointment of Sebastian James as a Non-Executive Director. Following a review of the expertise and experience of members of the Board, the Committee produced a detailed candidate brief and engaged external search consultants, JCA Group, to find suitable candidates. JCA Group is a signatory to the Voluntary Code of Conduct for executive search firms and has no other connection to the Company. A long list of candidates of appropriate merit from diverse backgrounds was prepared and the Committee agreed a shortlist and interviewed candidates. It then approached the PRA and FCA for approval, and recommended Sebastian James' appointment as a Non-Executive Director to the Board.

Sebastian James, having been appointed during the year, will submit himself for election at the Company's 2015 AGM. Sebastian James is considered independent within the meaning of the Code.

## Election and re-election of Directors

Before the proposed re-election of Directors at the 2014 AGM, the Committee reviewed the independence of Non-Executive Directors. It concluded that Jane Hanson, Glyn Jones, Andrew Palmer, Clare Thompson and Priscilla Vacassin were all independent within the meaning of the UK Corporate Governance Code. Mike Biggs was independent on his appointment as Chairman. The Committee recommended to the Board and shareholders that all serving Directors be re-elected at the Company's 2014 AGM.

## Diversity

The Group celebrates the diversity of its workforce. We seek to recruit the best candidates for all positions throughout the business, irrespective of gender. Three of our nine Directors are women (33% of the Board). This level exceeds the target recommended by the Davies Report on boardroom diversity. The Board acknowledges the benefit of diversity. The Nomination Committee has encapsulated in its terms of reference a requirement to consider candidates for appointment to the Board on merit, against objective criteria and with due regard to diversity, including gender diversity.

You can find more information on the Group's approach to diversity in the CSR section on pages 32 to 35.

## Effectiveness of the Nomination Committee

The 2013 Board and Committee effectiveness review identified the need for greater focus on succession planning. This was incorporated into the Nomination Committee's agenda for 2014. The Committee has reviewed the Executive and Non-Executive Director succession plans. It has also guided management on succession planning, in particular identifying, assessing and developing potential among senior executives.

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

The Board reviewed and approved this report on 2 March 2015.

**Michael N Biggs,** Chair of the Nomination Committee

# Remuneration Committee report

**Priscilla Vacassin,**
Chair of the Remuneration Committee

## Role of the Remuneration Committee

The Committee is responsible for setting and overseeing the implementation of the Group's remuneration policy. The Committee oversees the level and structure of remuneration arrangements for senior executives, approves share incentive plans, and recommends to the Board share plans and, when applicable, changes to share plans requiring shareholder approval.

You can find the Remuneration Committee's terms of reference at www.directlinegroup.com .

## Committee composition, skills and experience

The Committee comprises three independent Non-Executive Directors: Priscilla Vacassin; Sebastian James; and Andrew Palmer; and the Board Chairman, Mike Biggs. You can find the members' biographical information on pages 52 to 53.

On 30 September 2014, Sebastian James was appointed as a member of the Committee, and Clare Thompson retired as a member.

## Meetings

The Remuneration Committee held eight scheduled meetings in 2014, one of which was a joint meeting with the Board Risk Committee to discuss matters relating to overlapping remits between the two Committees. Additionally, two meetings were held to deal with matters arising during the year. The following table sets out attendance at the scheduled meetings:

| | Scheduled meetings[1] | Percentage attendance |
|---|---|---|
| Priscilla Vacassin (Chair) | 8 of 8 | 100% |
| Mike Biggs | 8 of 8 | 100% |
| Sebastian James | 1 of 1 | 100% |
| Andrew Palmer | 8 of 8 | 100% |
| Clare Thompson | 7 of 7 | 100% |

Note:

1. Attendance is expressed as the number of scheduled meetings attended out of the number of such meetings possible or applicable to attend.

The Chief Executive Officer, Human Resources Director and senior representatives of the Human Resources function are invited to attend Remuneration Committee meetings. FIT Remuneration Consultants LLP, who act as independent advisers to the Committee, are also invited to attend Remuneration Committee meetings.

The Chair reports on matters dealt with at each Committee meeting to the subsequent scheduled Board meeting.

### Remuneration Committee focus during 2014

- Considered the continued suitability of the current remuneration framework
- Reviewed regulatory developments relating to remuneration and considered the implications for the Group
- Reviewed the share-ownership guidelines for senior executives and the extent of compliance with the guidelines
- Determined the 2013 bonus pool and individual allocations to senior executives, in light of the performance of the business, advice from the Chairs of the Audit and Board Risk Committees, the audit of the Group's results, and individual performance
- Determined that no clawback of awards under the Annual Incentive Plan ("**AIP**") was required in 2014
- Considered the implications of selling the Group's International division on remuneration at the International division and Group levels
- Considered the compensation for senior executives joining and leaving the Group
- Considered management recommendations for a restricted share award to outstanding employees not eligible for the Long-Term Incentive Plan ("**LTIP**"), and approved a proposal for a free share award to all employees
- Determined the quantum of awards under the LTIP, in view of business and individual performance
- Considered the required approach for the AIP for employees in control functions, including Risk and Group Audit
- Approved the metrics and targets for the 2014 AIP
- Worked with the Board Risk Committee to ensure risk management metrics were considered and included when assessing the performance of senior executives, and incorporated into the incentive schemes for customer facing roles and for technicians and support staff in the accident and repair centres
- Reviewed the compensation for Executive Directors and supervised the compensation review for members of the Executive Committee, other senior executives and other employees

## Effectiveness of the Remuneration Committee

The Company Secretary facilitated the Committee's review of its effectiveness during the year. The Company Secretary also prepared a report based on responses from the members of the Committee and other stakeholders to a pre-agreed questionnaire. Having reviewed and discussed the resulting report, the Committee concluded that it was effective and has access to sufficient resources to perform its duties.

The Board reviewed and approved this report on 2 March 2015.

**Priscilla Vacassin,** Chair of the Remuneration Committee

**Priscilla Vacassin,**
Chair of the Remuneration Committee

## Dear shareholder

As Chair of the Remuneration Committee (the "**Committee**"), I am pleased to introduce our report on Directors' remuneration. Our remuneration policy has been in place since the IPO, and received a significant level of support from shareholders at the 2014 AGM (97.5% of votes cast).

You can find a copy of the approved policy on pages 84 to 93 of this report.

### Linking remuneration to performance – key pay outcomes in respect of 2014

As outlined in the Board Chairman's letter on pages 10 to 11, we have met or exceeded the stretch targets which we set ourselves before the IPO. The incentive outcomes for our Executive Directors, as presented in the annual remuneration report on pages 77 to 83, and for other senior executives and employees, reflect these achievements.

In line with last year's approach, bonuses under the Annual Incentive Plan ("**AIP**") are based on performance against key financial and strategic measures. Bonuses of 75% of the maximum were awarded to the Chief Executive Officer and the Chief Financial Officer in respect of 2014. This reflects the strong performance against our financial targets and the significant progress made during the year in achieving our strategic priorities.

In arriving at this outcome, as in previous years, the Committee has exercised careful judgement, assessing the quality of earnings and the overall context for performance to ensure that bonus outcomes are fair for shareholders and executives. We have provided enhanced disclosure this year in relation to the AIP outcome for 2014 on page 77 of this report.

Under our Long-Term Incentive Plan ("**LTIP**"), the first awards, which were made following the IPO, and are subject to total shareholder return ("**TSR**") and RoTE performance conditions, are due to vest later in 2015. The performance period in respect of the RoTE element of these awards has now been completed. Subject to final determination by the Committee at the time of vesting, the RoTE delivered in 2013 and 2014 has resulted in achievement of 82% of the maximum opportunity for this element. These shares will not be delivered to Executive Directors until November 2015, when the Committee will also assess performance under the TSR element of the award. Awards will only vest to the extent that the Committee is satisfied at that time that the outcome reflects the Group's underlying financial performance and there have been no material risk failings.

Separately, this year also saw the completion of the performance period for the last legacy awards under the RBS Group long-term incentive plan ("**RBS Group LTIP**"). These awards were granted to Executive Directors, and other senior executives, in respect of their work as executives of RBS Insurance, as Direct Line Group was known when it was owned by the RBS Group. The assessment against the performance framework set by RBS Group at the time of grant against financial, operational, risk and strategic measures, has resulted in vesting of 90% of awards. As agreed with RBS Group at the time of the IPO, these awards will be delivered in the form of Direct Line Insurance Group plc (the "**Company**") shares, transferred by RBS Group.

The vesting outcomes described above under both the Direct Line Group LTIP and RBS Group LTIP have been included in the single figure of remuneration which is shown on page 77.

### Remuneration approach for 2015

Our remuneration policy has worked well and continues to be aligned with our key strategic priorities. Therefore, we are not making any changes to the approved policy this year but have refined aspects of our practices which do not require shareholder approval and which will help further align our executives and shareholders and will continue incentivising superior and sustainable business performance.

You can find more details of these changes in the section of this remuneration report that describes how we intend to implement our remuneration policy in 2015 on pages 74 to 76.

I would like to highlight the following areas:

- The salaries of both Executive Directors will increase by 2% in April 2015, in line with the average increase to employees across the Group generally. This will be the first increase since their salaries were set in September 2012
- Our approach to measuring performance under the AIP in 2015 will be similar to that followed in 2013 and 2014. We will continue to measure performance using specific financial, strategic and personal targets and carefully assessing payouts using broader judgement. The Committee will continue to consider lead indicators, costs and prior-year reserve releases as part of its overall judgement but there will be no specific weighting allocation to these elements

- To reflect the Group's continued focus on customer experience, in 2015 we will be increasing the weighting of customer measures under the AIP from 10% to 20%. We will also increase the range of customer measures taken into account to better reflect the specific focus for the coming year
- We are not proposing any changes to the performance conditions for 2015 awards under the LTIP. However, we will be increasing the level of RoTE required for 2015 awards to vest from the current range of 14.0% to 17.0% to the range 14.5% to 17.5%. This will ensure that awards to Executive Directors will only vest in full if significant value has been delivered to our shareholders
- To further strengthen the alignment of Executive Directors' and shareholders' interests we have increased the share ownership guidelines for the Chief Financial Officer from 150% to 200% of base salary, aligning them with those of the Chief Executive Officer

During the year, the Committee also considered if it would be appropriate to introduce a requirement to hold any awards under the LTIP for a further period following vesting. The Committee decided that, pending final guidance on the requirements of Solvency II expected during 2015 and which may well include guidance on this aspect necessitating further change, it would not change the policy at this stage. The Committee will review remuneration structures and policy once the final Solvency II requirements have been published.

### Voting on the annual remuneration report

As we are not proposing any changes to our remuneration policy which would require shareholder approval, the annual report on remuneration will be the only report to be put to an advisory shareholder vote at the AGM on 13 May 2015.

I believe the remuneration our Executive Directors received in 2014 is appropriate and rewards them fairly for their performance and that their remuneration arrangements for 2015 will continue to incentivise them to deliver our strategic priorities and provide our shareholders with sustainable returns.

I hope you find this report informative and welcome any feedback you may have.

**Priscilla Vacassin,**
Chair of the Remuneration Committee

## Questions and answers on our executive remuneration policy

### Q How did you determine the bonuses for 2014 for the Executive Directors?

Similar to last year, we began by quantitatively assessing performance under each measure. This gave the Committee an initial view on delivery against the targets set at the start of the year.

We then considered a wide range of additional quantitative and qualitative factors. These included quality of earnings, affordability, the Group's overall performance against the agreed risk profile, performance relative to peers, the wider economic environment plus other factors. This allowed the Committee to consider the overall Group performance and ensure bonuses reflect this.

As described in the Remuneration Committee Chair's letter on page 71, this assessment resulted in achievement of 75% of the maximum opportunity in respect of both Executive Directors.

As in previous years, for both Executive Directors 40% of the awarded bonus will be deferred in Company shares for three years. This is in line with the approach for other Executive Committee members and strategic leaders (our most senior executives, who are responsible for developing and executing Group strategy).

### Q Will the 2015 process be different?

It will be broadly unchanged. Our overall framework for determining bonuses has existed since the IPO, and has proved effective in linking business performance with payments to the Executive Directors. However, we have refined some of its details, making it easier to operate and communicate.

We particularly wanted to broaden the factors the Committee considers when assessing performance. Therefore, to that effect we have moved the consideration of lead indicators, costs and prior-year reserve releases to the overall judgement applied by the Committee in considering outcomes as opposed to applying a specific weighting.

The other change in 2015 will be to increase the scope and the weighting of the customer measures.

You can find more details on these changes on page 75.

### Q Do you comply with the Financial Conduct Authority's Remuneration Code?

As an insurance business, we are not subject to the provisions of the Financial Conduct Authority's Remuneration Code. However, we seek to comply with the core requirements of the Code that we should establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management.

As such, significant elements of performance related pay for all our strategic leaders and Executive Committee members, including Executive Directors, are subject to deferral and potential malus and clawback. This is explained further in our policy report.

We also assess bonuses for senior personnel in our control functions independently from the Group financial results. This helps maintain the independence of our control functions.

### Q How are you preparing to comply with Solvency II remuneration requirements?

Guidance in relation to the pay implications of Solvency II remains draft and high level, with final guidance not expected until after the publication of this report. In 2014, we thoroughly assessed our remuneration arrangements against known guidance with help from external advisers. The results confirmed that we already achieve a high level of compliance with the draft guidance.

When we know the final provisions we will fully review our remuneration policy and practices and consider whether we need to change them. We will disclose any changes affecting our Executive Directors' remuneration arrangements in subsequent remuneration reports as appropriate.

### Q Why are the Executive Directors still receiving shares under RBS Group share plans?

In line with other Direct Line Group employees previously granted awards under RBS Group employee share plans, Paul Geddes and John Reizenstein were granted awards under the RBS Group LTIP and the RBS Group Deferral Plan prior to the IPO, when they were employees of RBS Group.

In the case of awards under the RBS Group LTIP, the last set of outstanding awards is due to vest in March 2015, as described in more detail in the Committee Chair's letter on page 71. These awards will be delivered in the form of Direct Line Insurance Group plc shares, transferred by RBS Group as agreed at the time of the IPO.

The remaining RBS Group Deferred awards are also due to vest in March 2015 and will be delivered in RBS Group shares. These awards are not subject to any performance conditions as they represent the deferral element of annual bonuses that have already been earned.

### Q How will the sale of the International division affect remuneration arrangements for Executive Directors?

Completion of the sale of our International division is currently expected in the first quarter or failing which in the second quarter. As this sale was not completed during 2014, we did not adjust the AIP targets for 2014, which continued to include the performance of the International division.

For existing awards under the LTIP, in line with typical market practice, we will not adjust performance targets under the TSR or RoTE elements.

Future performance targets for the AIP and the RoTE element of the LTIP have been set after taking the impact of the sale of the International division, and its impact on our budget and business plans, into account.

### Q Do you offer all your employees the opportunity to become shareholders?

Yes, we believe it is important for all employees to have the opportunity to become shareholders in the Company. We run a Buy-As-You-Earn Share Incentive Plan (the "**SIP**") which allows employees to receive one matching share for every two shares they purchase.

In addition, in order to recognise the exceptional contribution of our people to the success of our business, we announced during December 2014 a free share award with a value of £400 per employee in the UK. This award will be made during March 2015 and will be the second offer of free shares to UK employees since the IPO.

# Introduction

The remuneration report has been prepared in accordance with the requirements of the Companies Act 2006 and The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the "**Regulations**"). The Company also complies with the UK Corporate Governance Code in relation to remuneration.

# Annual remuneration report

### Remuneration Committee members and governance

The following list details members of the Remuneration Committee during 2014. You can find information about each member's attendance at meetings in the Remuneration Committee report on page 69. Their biographies can be found on pages 52 to 53.

**Committee Chair**

Priscilla Vacassin

**Non-Executive Directors**

Mike Biggs

Sebastian James (appointed to Committee on 30 September 2014)

Andrew Palmer

Clare Thompson (retired from Committee on 30 September 2014)

### Advisers to the Committee

The Committee consults with the Chief Executive Officer, the Human Resources Director and senior representatives of the HR function on matters relating to the appropriateness of all remuneration elements for Executive Directors and Executive Committee members. The Chief Executive Officer and the Human Resources Director are not present when their own remuneration is discussed. The Committee works closely with the Chairs of the Board Risk Committee and the Audit Committee.

The Committee retains FIT Remuneration Consultants LLP ("**FIT**"), who are signatories to the Remuneration Consultants Group's Code of Conduct, as its independent adviser. This appointment was made by the Committee in preparation for the IPO and following consideration of the firm's experience in this sector. FIT was reappointed by the Committee during the year following a review of its performance.

During the year, FIT provided advice on market practice, corporate governance, incentive plan design, regulatory and other matters under consideration by the Committee. FIT does not provide any other services to the Company, and accordingly the Committee is satisfied that the advice provided by FIT is objective and independent.

FIT's total fees for remuneration-related advice in 2014 were £175,332 exclusive of VAT. FIT charged its fees on the basis of its standard terms of business for providing advice.

Allen & Overy LLP, one of the Group's legal advisers, also provided legal advice relating to the Group's executive remuneration arrangements, and provided the Group with other legal services.

## Statement of implementation of policy in 2015

### Executive Directors' salaries in 2015

The current base salaries paid to the Executive Directors were set before the IPO. The Committee has considered the current level of salaries and decided to award an increase of 2% from 1 April 2015, in line with the average increase awarded to UK employees.

| Director | Position | 2015 base salary £'000 | 2014 base salary £'000 | Annual change in base salary |
|---|---|---|---|---|
| Paul Geddes | Chief Executive Officer | 775 | 760 | 2% |
| John Reizenstein | Chief Financial Officer | 469 | 460 | 2% |

### Annual Incentive Plan 2015

The maximum annual incentive awards which may be payable to Executive Directors in respect of 2015 are shown below and have remained unchanged since the IPO.

| Director | Position | Maximum annual incentive award for 2015 (% base salary) | Deferred under the Deferred Annual Incentive Plan |
|---|---|---|---|
| Paul Geddes | Chief Executive Officer | 175% | 40% |
| John Reizenstein | Chief Financial Officer | 150% | 40% |

During 2014, the Committee reviewed the basket of measures used to assess performance under the AIP and the operation of the overall framework since it was put in place at the time of the IPO. The review concluded that, overall, the framework worked well in linking the variable pay of Executive Directors with the performance of the Group. However, as part of the review, the Committee decided to adopt the following changes aimed at simplifying the plan and further strengthening that link:

- In 2014, ongoing operating profit was adjusted to exclude movements in prior-year reserves. This adjustment will no longer be made in 2015 although the Committee will assess the impact of prior-year reserving on performance as part of its overall judgement. The weighting of ongoing operating profit has increased to 50%
- To remove the specific weighting for cost targets and lead indicators, but consider these factors as part of its overall exercise of judgement around the quality and sustainability of earnings
- To broaden the basket of customer measures and double the weighting of this element to 20%, reflecting the specific business priorities for the year ahead

| | Measures | Weighting for 2015 | Weighting for 2014 |
|---|---|---|---|
| Financial | Ongoing operating profit (no longer adjusted for prior-year reserving from 2015) | 50% | 40% |
| | Other financial measures not reflected in the definition of profit, primarily the performance of the Run-off segment and restructuring costs | 10% | 10% |
| | Cost targets | No specific weighting, but considered as part of the overall judgement | 10% |
| Strategic | A mix of financial and non-financial lead indicators including market share, retention, quote to conversion ratio, scored loss ratio, progress with technology and strategic projects and others | | 10% |
| | Based on a basket of customer measures including Net Promoter Score and complaints | 20% | 10% |
| Personal objectives | Defined objectives for each Executive Director, including shared objectives across the Executive Committee | 20% | 20% |

In line with previous years, all AIP outcomes will continue to be determined after the Committee determines a payment gateway. This requires the Committee to be satisfied that it is appropriate to permit a bonus award, at all or at a given level. The gateway necessarily involves some subjective judgement of performance. This may result in positive or negative moderation of each AIP performance measure or the overall bonus outcome.

The table below sets out the gateway criteria for the AIP for 2015.

### Gateway criteria for the Annual Incentive Plan for 2015 outcomes for Executive Directors

- Quality and sustainability of earnings, referring to reserving, gross written premium, costs and loss ratio, and relevant lead indicators
- Additional customer context, for example, conduct, experience, brand and franchise health
- Affordability
- Risk management within risk appetite
- The Group's relative performance to that of its peers
- The wider economic environment
- Exceptional events, such as abnormal weather
- Any regulatory breaches and / or reputational damage to the Group
- Committee satisfaction that paying the bonus does not cause major reputational concerns

The Committee may also use its discretion to take into account additional factors. These include the quality of financial results, the 'direction of travel' of all measures and a wider consideration of reputation, risk and audit.

### Performance conditions for Long-Term Incentive Plan awards

LTIP awards to be granted in 2015 will continue to be subject to performance against the following performance conditions:

- 60% based on RoTE over a three-year performance period (2015, 2016 and 2017)
- 40% based on relative TSR performance against the constituents of the FTSE 350 (excluding investment trusts) over a three-year performance period starting on the date of grant. The starting TSR and closing TSR will both be averaged over a three-month period

For these purposes, we use the Group's standard definition for RoTE, see page 170, subject to other adjustments which the Committee may consider appropriate.

Following the year end, the Committee reviewed the performance targets and, in line with its commitment to ensure that awards to Executive Directors would only be payable if significant value has been created for shareholders, decided to increase the RoTE target range as follows:

| | | Performance required for threshold vesting | | Performance required for maximum vesting | |
|---|---|---|---|---|---|
| Performance measure | Vesting for threshold performance | Awards for 2015 | Awards made prior to 2015 | Awards for 2015 | Awards made prior to 2015 |
| RoTE | 20% of this element of the award | Average annual RoTE performance of 14.5% | Average annual RoTE performance of 14.0% | Average annual RoTE performance of 17.5% | Average annual RoTE performance of 17.0% |
| Relative TSR | 20% of this element of the award | Median | | Upper quintile | |

For the TSR and RoTE elements, 20% of the award vests for threshold performance with 100% vesting for maximum performance. There is a straight-line interpolation between these points for the TSR element (on a ranked basis). For the RoTE element, 40% of the award will vest for RoTE of 15.5% for awards to be made in 2015 (previously 15%). Otherwise, similar to TSR, a straight-line interpolation occurs from threshold to target then from target to maximum performance.

The LTIP awards will also vest only to the extent that the Committee is satisfied that the outcome of the TSR and RoTE performance conditions reflects the Group's underlying financial performance from the date of grant until vesting. When considering these matters, the Committee will consider whether there have been any material risk failings.

### Pension and benefits

A pension contribution of 25% of base salary will continue to be paid to both Executive Directors in 2015. This is shown in the table below.

| Director | Position | Pension contribution (% base salary) |
|---|---|---|
| Paul Geddes | Chief Executive Officer | 25% |
| John Reizenstein | Chief Financial Officer | 25% |

Benefits comprise the provision of a company car or car allowance, private medical insurance, life assurance, income protection and health screening. The Executive Directors are also eligible for certain discounted Group products in line with the approach for all employees.

### Non-Executive Director fees

The current fees for the Chairman and Non-Executive Directors were set in 2012 and have not been changed to date.

| Position | Fees for 2015 £'000 |
|---|---|
| Board Chairman fee | 400 |
| Basic Non-Executive Director fee | 70 |
| **Additional fees** | |
| Senior Independent Director fee | 30 |
| Chair of Audit, Risk and Remuneration Committees | 30 |
| Chair of CSR Committee | 10 |
| Member of Board Committee (Audit, Risk or Remuneration) | 10 |
| Member of Board Committee (CSR or Nomination) | 5 |

No additional fees are paid for membership or chairmanship of the Investment Committee.

### External directorships

The Company encourages Executive Directors to accept, subject to the approval of the Chairman, an invitation to join the board of another company outside the Group in a non-executive capacity. This recognises the value of such wider experience. In these circumstances, they can retain any remuneration from the non-executive appointment. Executive Directors are generally limited to accepting one external directorship.

John Reizenstein is a trustee and director of Farm Africa, for which he receives no fees, otherwise the Executive Directors do not hold any external directorships.

## Implementation of policy and pay outcomes in relation to 2014 performance

### Single figure table[1] (audited)

| £'000 | Salary | | Annual bonus[2] | | Long-term incentives[3,4,5] | | Benefits[6] | | All employee share plans[7] | | Pension contributions and cash allowance in lieu of pension | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Paul Geddes | 760 | 760 | 1,000 | 835 | 2,656 | 728 | 17 | 23 | – | – | 190 | 190 | 4,623 | 2,536 |
| John Reizenstein | 460 | 460 | 518 | 415 | 830 | 158 | 15 | 14 | 1 | 1 | 115 | 115 | 1,939 | 1,163 |

Notes:

1. All figures in the table are rounded to the nearest thousand.
2. Includes amounts earned for performance during the year, but deferred for three years under the Deferred Annual Incentive Plan ("**DAIP**"), see page 81. These deferred awards are not subject to any conditions except continuous employment although awards remain available for malus / clawback.
3. Long-term incentives in 2013 and 2014 represent the vesting of the RBS Group LTIP awards granted in 2011 and 2012 respectively. The expected vesting outcome figures for the RBS Group LTIP awards granted in 2011 reported in 2013 have been updated based on the actual vesting share price of £2.652 on 7 March 2014, compared to the three month average share price of £2.2658 used in reporting this figure in the 2013 remuneration report. This results in an adjusted reportable increase of approximately £106,000 for Paul Geddes and £23,000 for John Reizenstein, with a corresponding increase by the same amounts of the single figure for 2013. For the RBS Group LTIP awards granted in 2012, the vesting outcome is calculated at 90% of shares under award resulting in a value of £2,028,470 for Paul Geddes and £456,403 for John Reizenstein. Details of the performance measures applicable to the vesting of RBS Group LTIP awards are shown on page 83.
4. The long-term incentive figures for 2014 also include the estimated vesting outcome for the RoTE portion of the awards made under the Direct Line Group LTIP in November 2012. In line with the criteria set at the time of grant, this has been assessed by reference to RoTE performance during 2013 and 2014 at 49.2% of shares under award (82% of the maximum in relation to the RoTE element). The corresponding values under long-term incentives, including the value of dividends accrued, are £617,636 for Paul Geddes and £373,826 for John Reizenstein. These shares will be delivered to Executive Directors in November 2015.
5. The values shown under long-term incentives for 2014 are based on the three month average Company share price to 31 December 2014. The LTIP figure for 2014 for Paul Geddes also includes the value on exercise of 4,206 dividend shares on his DAIP award for 2012 in March 2014 of £10,157.
6. Benefits include a company car or allowance, and private medical and income protection insurance.
7. Includes the value of matching shares under the SIP.

Each Executive Director has confirmed that they have not received any other items in the nature of remuneration, other than those already disclosed in the single figure table.

### Annual Incentive Plan outcomes for 2014

The table below shows outcomes against the specific measures during the year:

| Measures | | | Weight (as a % of maximum award) | Achievement against performance measures (Threshold 10% vesting; Target 60% vesting; Maximum 100% vesting) |
|---|---|---|---|---|
| Financial | Adjusted ongoing operating profit | | 40% | 90% |
| | Other financial measures not reflected in the definition of ongoing operating profit[1] | | 10% | 80% |
| | Cost reduction targets | | 10% | 60% |
| Strategic | A mix of financial and non-financial lead indicators[2] | | 10% | 60% |
| | Customer experience | | 10% | 60% |
| Personal | Personal objectives including shared objectives amongst all Executive Committee members | Paul Geddes | 20% | 66% |
| | | John Reizenstein | 20% | 65% |

Notes:

1. Primarily movements in prior-year reserves, the performance of the Run-off segment and restructuring costs
2. Including market share, retention, quote to conversion ratio, scored loss ratio, progress with technology and strategic projects

As reported in last year's report, at the start of the year, the Committee did not set a formal threshold to maximum range for performance measures. Instead, the Committee believed it was more appropriate to consider performance relative to targets, those numbers being commercially sensitive and likely to remain so, and assess over or underperformance by judging overall performance at the year end. The outcomes shown above, therefore, reflect the strong performance during the year, particularly in terms of the financial measures, as highlighted in the Group highlights and Chairman's statement on pages 4 to 5 and 10 to 11 respectively.

Consequently, the annual incentive awards payable to the Executive Directors for the financial year ended 31 December 2014 are as follows:

| Director | Position | Maximum annual incentive award (% of base salary) | Actual annual incentive award for 2014 (% of base salary) | Actual annual incentive award for 2014 (including cash and deferred element) £'000 |
|---|---|---|---|---|
| Paul Geddes | Chief Executive Officer | 175% | 132% | 1,000 |
| John Reizenstein | Chief Financial Officer | 150% | 113% | 518 |

### Non-Executive Directors

Remuneration for the Non-Executive Directors for the year ended 31 December 2014 is shown in the table below. Fees were the only remuneration paid to the Non-Executive Directors in 2013 and 2014. Non-Executive Directors may also claim for reasonable travel expenses in accordance with the Group's travel and expenses policy.

| Director | Fees[1] £'000 | Total 2014 £'000 | Total 2013 £'000 |
|---|---|---|---|
| Michael Biggs | 400 | 400 | 400 |
| Glyn Jones | 115 | 115 | 115 |
| Jane Hanson[2] | 119 | 119 | 120 |
| Sebastian James[3] | 28 | 28 | – |
| Andrew Palmer | 125 | 125 | 125 |
| Clare Thompson[4] | 104 | 104 | 105 |
| Priscilla Vacassin | 110 | 110 | 110 |
| Mark Catton[5] | – | – | – |

Notes:

1. Non-Executive Directors are not eligible to participate in any of the Group's bonus or share incentive schemes or join any Group pension scheme.
2. Jane Hanson remained a member of the Corporate Social Responsibility Committee through 2014, but stood down as Chair from 1 October 2014.
3. Sebastian James was appointed to the Board as a Non-Executive Director on 28 August 2014. The fees for membership of the Remuneration Committee and Corporate Social Responsibility Committee applied from 30 September 2014.
4. Clare Thompson stood down from the Remuneration Committee from 30 September 2014.
5. Mark Catton, a Director nominated by RBS Group, resigned as a Director of Direct Line Insurance Group plc on 26 April 2013, following the reduction in the shareholding of RBS Group in Direct Line Insurance Group plc to less than 50% on 13 March 2013. He was reappointed as a Director on 1 October 2013 following Bruce Van Saun's resignation. He later resigned on 7 March 2014. During their appointment as Non-Executive Directors, Bruce Van Saun and Mark Catton were RBS Group employees with any fees received payable to RBS Group. A lump sum payment in respect of Directors' fees for Mark Catton and Bruce Van Saun for the years 2012 to 2014 inclusive of £133,579 was paid in January 2015.

### Percentage change in pay of Chief Executive Officer 2013 to 2014

The table below shows the year-on-year percentage change in salary, taxable benefits and bonus for the Chief Executive Officer compared to the average remuneration of all other UK employees. The Committee considers that it is appropriate to compare against all UK employees, but to exclude those based outside the UK. This helps ensure consistent comparisons with the Chief Executive Officer.

| | Salary[1] | Benefits[2] | Bonus (including deferred amount)[3] |
|---|---|---|---|
| Chief Executive Officer | Nil | -26% | 20% |
| All UK employees | 2.6% | -6% | 20% |

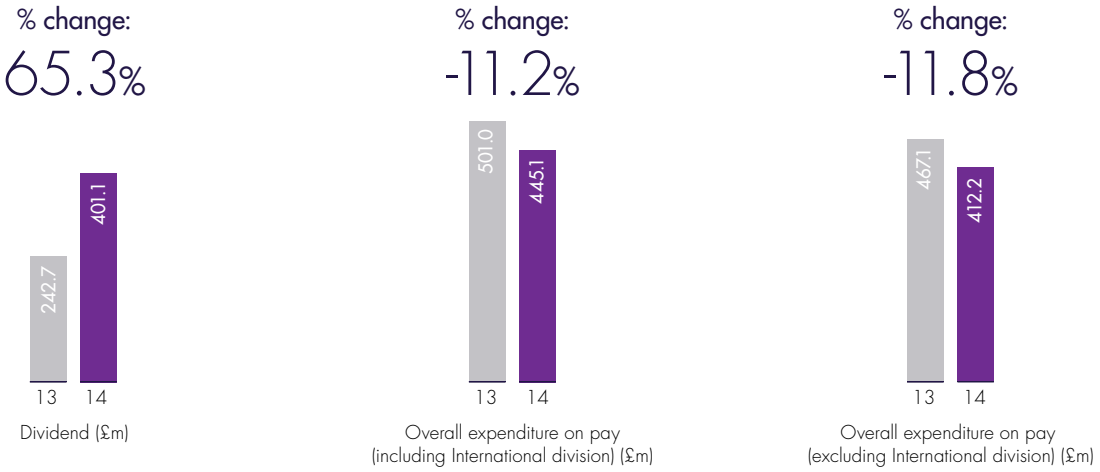
Notes:

1. Based on the change in average pay for UK employees employed in both the year ended 31 December 2014 and the year ended 31 December 2013.
2. There were no changes in benefit provision between 2013 and 2014. The decrease in value shown is due to a decrease in the cost associated with the provision of certain benefits.
3. Includes average amounts earned under the Annual Incentive Plan and, for employees other than the Chief Executive Officer, other variable incentive schemes, including monthly and quarterly incentive schemes operated in certain parts of the Group.

When determining Directors' remuneration, the Committee considers employment conditions elsewhere in the Group. The Committee particularly reviews overall pay and bonus decisions in aggregate for the wider Group. Through the Chief Executive Officer, Paul Geddes, and other senior management, the Committee may receive input provided by employee groups, such as the Employee Representative Body as required.

### Distribution statement

The following chart shows the overall pay expenditure across all Group employees compared with the total value of dividends paid to shareholders for 2013 and 2014.



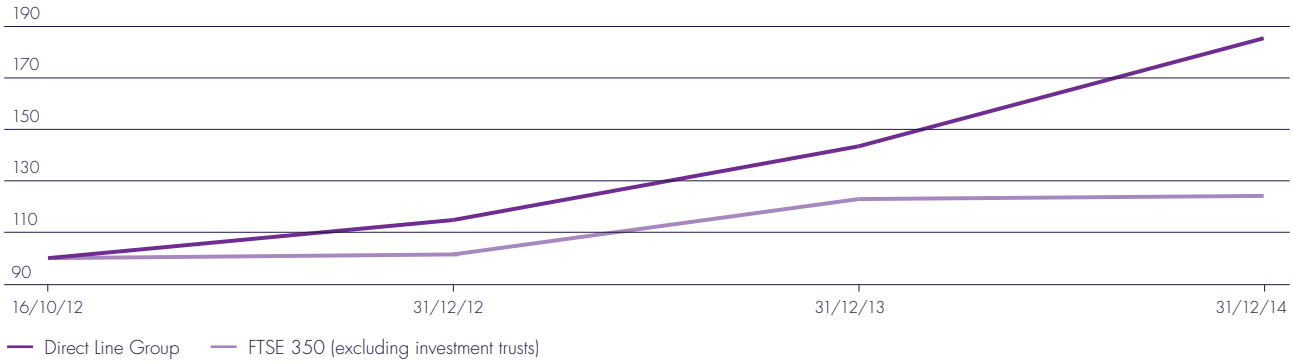

Note:

There have been no share buy-backs since the IPO other than shares purchased by the Employee Benefit Trusts to satisfy the awards of shares under the Company's share plans. Consistent with market practice, the overall expenditure on pay has been taken from note 11 to the consolidated financial statements. Therefore it has not been calculated in a manner consistent with the single figure in this report.

### Historical performance of Total Shareholder Return

The following graph shows the Company's TSR since trading of the Company's shares began on the London Stock Exchange in October 2012 against the FTSE 350 Index (excluding investment trusts) over the same period. The FTSE 350 Index (excluding investment trusts) has been selected as it is a broad index, of which the Company is a constituent. It also represents the same group of companies used for measuring relative TSR under the LTIP.

### Total Shareholder Return




The table below shows historical levels of the Chief Executive Officer's pay between 2012 and 2014. It also shows vesting of annual and long-term incentive pay awards as a percentage of the maximum available opportunity.

| Chief Executive Officer | Single figure of total remuneration £'000 | Annual bonus payout (% of maximum) | Long-term incentive vesting (% of maximum)[1] |
|---|---|---|---|
| 2014 | 4,623 | 75% | 88% |
| 2013 | 2,536 | 63% | 55% |
| 2012 | 1,908 | 65% | 30% |

Note:

1. Based on actual vesting under the 2010 and 2011 and expected vesting under the 2012 RBS Group LTIP. The value included in the single figure in respect of these awards is £205,000 in 2012, £728,000 in 2013 and £2,028,470 in 2014. For 2014, the estimated vesting of the RoTE portion of the Direct Line Group LTIP granted in 2012 has also been included at a value of £617,636. Any shares vesting under the Direct Line Group LTIP will not be delivered until November 2015 but have been included in the single figure as the performance period in respect of the RoTE portion has now been completed.

### Voting outcomes from 2014 Annual General Meeting

The table below shows the percentage of shareholders voting for, or voting against, and the percentage of votes withheld in relation to the resolutions to approve the Directors' remuneration policy and Directors' annual remuneration report put to the Annual General Meeting ("**AGM**") in 2014.

| | For | | Against | | | |
|---|---|---|---|---|---|---|
| | Number | Percentage | Number | Percentage | Number of votes withheld (abstentions) | Percentage votes withheld (abstentions |
| Approval of Directors' remuneration policy | 1,064,002,114 | 97.5% | 26,743,783 | 2.5% | 1,945,618 | 0.2% |
| Approval of Directors' remuneration report | 1,069,454,199 | 98.0% | 21,291,566 | 2.0% | 1,945,750 | 0.2% |

Note:

The percentages of votes for and against are expressed as a percentage of votes cast, excluding abstentions. The percentage of votes withheld is expressed as a percentage of total votes cast, including abstentions.

The Committee takes into account the approval levels of remuneration related matters at the AGM to determine whether the current Directors' remuneration policy remains appropriate.

The Committee aims to build an active and productive dialogue with investors on developments in the remuneration aspects of corporate governance generally and changes to the Company's executive pay arrangements in particular.

The Committee is satisfied that no element of the Directors' remuneration policy conflicts with the Group's approach to environmental, social or corporate governance matters.

### Shareholdings

The Executive Directors are subject to Share Ownership Guidelines. As such they are expected to retain all of the Ordinary Shares that they obtain from any of the Company's share incentive plans until they have achieved the required shareholding level. This is after any disposals necessary to pay personal taxes on acquiring such Ordinary Shares. For these purposes, the holding of Ordinary Shares will be treated as including all vested but unexercised awards, valued on a basis that is net of applicable personal taxes.

During the year, and in accordance with the power conferred to it by the Directors' remuneration policy, the Committee reviewed the level of Share Ownership Guidelines for both Executive Directors and aligned the guideline for the Chief Financial Officer (previously 150% of salary) to that of the Chief Executive Officer (200% of salary). The extent to which Executive Directors achieved the guideline requirements by 31 December 2014 is:

| Position | Share Ownership Guideline (% of salary) | Value of shares held at 31 December 2014 (% of salary) |
|---|---|---|
| Chief Executive Officer | 200% | 104.1% |
| Chief Financial Officer | 200% | 61.6% |

The table below shows the total share interests of each Executive Director.

| Director | Position | Share plan interests at 31 December 2014 | | | Beneficial share interests | |
|---|---|---|---|---|---|---|
| | | Share plan awards subject to performance conditions[1] | Share plan awards not subject to performance conditions[2] | Share plan interests exercised[3] | Shares held at 31 December 2014[4,5,6] | Shares held at 31 December 2013[5] |
| Paul Geddes | Chief Executive Officer | 2,488,902 | 218,790 | 391,833 | 271,472 | 58,768 |
| John Reizenstein | Chief Financial Officer | 1,203,368 | 137,347 | 59,713 | 97,352[7] | 60,904 |

Notes:

1. Includes awards under the RBS Group LTIP and Direct Line Group LTIP. As described in the notes to the single figure table, 90% of Direct Line Insurance Group plc shares in respect of awards granted to each Executive Director under the RBS Group LTIP are expected to vest in March 2015. For single figure purposes, using the three month average share price to 31 December 2014, these shares have been valued at £2,028,470 for Paul Geddes and £456,403 for John Reizenstein.
2. Includes matching and free shares held under the SIP, see page 82, and deferred shares under the DAIP. RBS Group deferred awards are not included as these will be settled in RBS Group shares.
3. 20% of the shares awarded to Paul Geddes under the DAIP in March 2013 vested during the financial year, consistent with the policy applying at RBS Group. These figures also include awards vested during the year under the 2011 RBS Group LTIP.
4. As at the date of this report the number of shares beneficially held by John Reizenstein had increased to 97,438. There was no change to the number of shares beneficially held by Paul Geddes.
5. Includes holdings of connected persons, as defined in section 96B(2) of the Financial Services and Markets Act 2000.
6. The DAIP and LTIP plan rules provide that all dividends accruing in the vesting period (or until exercise for awards made in 2012 and 2013) will be added on vesting. The table above excludes such roll up.
7. Beneficial share interests include partnership shares purchased by John Reizenstein under the SIP.

The table shows the beneficial interests of the Non-Executive Directors in the Company's shares as at 31 December 2014 and 31 December 2013.

| Director | Shares held at 31 December 2014[1,2] | Shares held at 31 December 2013 |
|---|---|---|
| Michael Biggs | – | – |
| Jane Hanson | 28,571 | 28,571 |
| Glyn Jones | 67,551 | 60,395 |
| Andrew Palmer | 11,428 | 11,428 |
| Clare Thompson | 33,775 | 30,197 |
| Priscilla Vacassin | 33,775 | 30,197 |
| Sebastian James | – | n/a |

Notes:

1. There were no changes to the number of shares held by Directors between the year end and the date of this report.
2. Includes holdings of connected persons, as defined in section 96B(2) of the Financial Services and Markets Act 2000.

## Direct Line Group share awards

### Direct Line Group Deferred Annual Incentive Plan awards made in 2014

The table below details the awards made to Paul Geddes and John Reizenstein under the DAIP relating to the bonus in respect of 2013, the monetary value of which was disclosed in full in last year's remuneration report.

| Director | Awards held at 1 January 2014 | Awards granted during the year[1] | Grant date | Three day average share price at grant date £ | Face value of award £ | Vesting date | DAIP dividend share award | Exercise[2] | Awards held at 31 December 2014 |
|---|---|---|---|---|---|---|---|---|---|
| Paul Geddes | 188,522 | 137,241 | 26 March 2014 | 2.433667 | 333,999 | 1 March 2014 – 26 March 2017 | 4,206 | 117,319 | 218,647[3] |
| John Reizenstein | 68,462 | 68,210 | 26 March 2014 | 2.433667 | 166,000 | 26 March 2017 | – | – | 136,672 |

Notes:

1. Awards are granted as nil-cost options.
2. Exercised on 27 March 2014 at £2.4330, resulting in an aggregate gain of £285,437.
3. Balance includes 5,997 shares relating to final dividend accruals from the DAIP award exercised on 28 March 2014 and which remain to be delivered.

### Direct Line Group Long Term Incentive Plan awards made in 2014

The table below details the unvested awards held by Paul Geddes and John Reizenstein made under the Company's LTIP.

| Director | Awards at 1 January 2014[1] | Awards granted during the year | Grant date | Three day average share price for grant of awards £ | Face value of award £ | Vesting date | Percentage of scheme interests that would be receivable if the minimum performance was achieved[2] | Awards held at 31 December 2014[3] |
|---|---|---|---|---|---|---|---|---|
| Paul Geddes | 1,117,729 | 312,285 | 26 March 2014 | 2.433667 | 759,998 | 26 March 2017 | 20% | 1,691,902 |
| | | 261,888 | 29 August 2014 | 2.9020 | 759,999 | 29 August 2017 | 20% | |
| John Reizenstein | 676,519 | 189,015 | 26 March 2014 | 2.433667 | 460,000 | 26 March 2017 | 20% | 1,024,045 |
| | | 158,511 | 29 August 2014 | 2.9020 | 459,999 | 29 August 2017 | 20% | |

Notes:

The Company's share price on 31 December 2014 was £2.913 and the range of prices in the year was £2.303 to £3.042.

1. These awards take the form of nil-cost options over the Company's shares and are subject to performance conditions to be assessed by the Committee. Awards granted prior to 2014 accrue dividend entitlements until the date of transfer of shares. Awards granted from 2014 accrue dividend entitlement from grant date to date on which an award vests.
2. The RoTE targets for awards up to 2014, applying to 60% of the award, were 14% for 20% vesting, 15% for 40% vesting and 17% for full vesting. A straight-line interpolation occurs from threshold to target and then from target to maximum performance. The remaining 40% of each award is based on TSR performance conditions which are the same as noted on page 76 for awards in 2015.
3. These figures do not include those RBS Group LTIP awards held by the Executive Directors. They are included in the table on page 83.

The Company's policy is to make awards twice a year following the announcement of the Group's full and half-year results. The value of each grant of awards is set at 50% of the normal annual policy level. This means the total face value of awards to each Executive Director during the year equates to 200% of base salary, measured using a three-day average share price prior to the date of grant.

### Direct Line Group 2012 Share Incentive Plan

During 2014 all employees, including Executive Directors, were eligible to invest from £10 up to £125 per month from their pre-tax pay into the SIP and receive one matching share for every two shares purchased. The limit of £125 per month was subsequently increased to £150 per month in January 2015 following legislation changes in 2014.

The table below details the number of shares held by John Reizenstein under the SIP. Paul Geddes does not participate in the plan.

| Director | Matching shares granted during the year | Matching shares cancelled during the year | Value of matching shares granted[1] £ | Balance of matching shares at 31 December 2014 |
|---|---|---|---|---|
| John Reizenstein | 278 | – | 750 | 532 |

Note:

1. The accumulated market value of matching shares at the time of each award. Purchase of the matching shares takes place within 30 days of the contributions being deducted from salary.

Additionally, at the time of the IPO, and under the same terms as other employees, Executive Directors were offered the opportunity to subscribe for 143 free Company shares which will vest in November 2015, three years from grant. Both Executive Directors subscribed for this offer. They were similarly eligible to participate in the award of approximately £400 worth of free shares due to be made in March 2015 as referred to in the Committee Chair's letter but have both waived their eligibility to this award.

### Dilution

The Company complies with the dilution levels recommended by the ABI guidelines, of 10% in 10 years for all share plans and 5% in 10 years for discretionary plans, consistent with the rules of the Company's share plans. Legacy RBS Group awards to be satisfied in Company shares will be satisfied by RBS Group rather than the Company and RBS Group has placed shares in trust to facilitate this.

## RBS Group Long-Term Incentive awards

The Executive Directors were granted awards in 2011 and 2012 under the RBS Group Long-Term Incentive Plan ("**RBS Group LTIP**") as employees of RBS Group. It was agreed that awards under this plan will be satisfied in Direct Line Insurance Group plc shares, transferred by RBS Group to the extent that the performance conditions, based on financial, risk, customer and people measures, have been satisfied.

| Director and scheme | Awards held at 1 January 2014 (Direct Line Group shares) | Awards vested during the year (Direct Line Group shares)[1] | Awards lapsed during the year (Direct Line Group shares) | Awards held at 31 December 2014 (Direct Line Group shares)[2] | Grant date | Market price at grant date (RBS Group shares) £ | Vest date |
|---|---|---|---|---|---|---|---|
| **Paul Geddes** | | | | | | | |
| 2011 | 501,394 | 274,514 | 226,880 | – | 7 March 2011 | 4.45 | 7 March 2014 |
| 2012 | 797,000 | – | – | 797,000 | 9 March 2012 | 2.80 | 9 March 2015 |
| **John Reizenstein** | | | | | | | |
| 2011 | 102,953 | 59,713 | 43,240 | – | 7 March 2011 | 4.45 | 7 March 2014 |
| 2012 | 179,324 | – | – | 179,324 | 7 March 2012 | 2.80 | 7 March 2015 |

Notes:

1. It was agreed with RBS Group that participants now employed by Direct Line Group holding awards under the RBS Group LTIP granted in 2011 and 2012 would be given the opportunity to have those awards satisfied by the transfer of Direct Line Insurance Group plc shares from RBS Group on vesting. The conversion rate applied to these awards was the average price of RBS Group shares over the five business day period prior to 11 October 2012 divided by the Direct Line Insurance Group plc share offer price (£1.75). This conversion equated to 1.487 Direct Line Insurance Group plc shares for every RBS Group share under grant. Both Executive Directors took up this offer.

2. As disclosed in the single figure table on page 77, 90% of the shares granted under the RBS Group LTIP in 2012 are expected to vest on the dates shown above. For single figure purposes this results in an estimated value of £2,028,470 for Paul Geddes and £456,403 for John Reizenstein.

## RBS Group deferred awards

Awards which were originally awarded under the RBS Group Deferral Plan will continue to be delivered in RBS Group shares. The awards detailed below under the RBS Group Deferral Plan give a conditional right to acquire ordinary shares in RBS Group. No awards were granted or lapsed during the year.

| Director and scheme | Awards held at 1 January 2014 (RBS Group shares) | Awards vested during the year (RBS Group shares) | Awards held at 31 December 2014 (RBS Group shares) | Grant date | Vesting dates |
|---|---|---|---|---|---|
| **Paul Geddes** | | | | | |
| 2011 | 17,981 | 17,981[1] | – | 7 March 2011 | 7 March 2012 – 7 March 2014 |
| 2012 | 64,310 | 32,154 | 32,156 | 9 March 2012 | 9 March 2012 – 9 March 2015 |
| **John Reizenstein** | | | | | |
| 2011 | 2,397 | 2,397[1] | – | 7 March 2011 | 7 March 2012 – 7 March 2014 |
| 2012 | 8,813 | 4,406 | 4,407 | 7 March 2012 | 7 March 2012 – 7 March 2015 |

Note:

1. Vested on 11 March 2014 when the RBS Group share price was £3.2012.

The Board reviewed and approved this report on 2 March 2015.

**Priscilla Vacassin,** Chair of the Remuneration Committee

# Policy report

A resolution in respect of the Directors' remuneration policy was approved at the Company's AGM on 15 May 2014 by a significant majority (97.5% in favour). No changes to the policy are proposed. For ease of reference, a copy of the policy approved by shareholders is repeated below (subject only to minor referencing updates to assist with the reading of the policy).

## Policy table

| Element | Purpose and link to strategy | Operation |
|---|---|---|
| **Base salary** | • This is the core element of pay that reflects the individual's role and position within the Group and is payable for doing the expected day-to-day job<br>• Ensuring we are competitive in the market allows us to attract, retain and motivate high calibre executives with the skill sets to achieve our key aims while managing costs | • Base salaries are reviewed annually and set in April of each year, although the Committee may undertake an out-of-cycle review if it determines that this is appropriate<br>• Salaries are typically reviewed against:<br>– level of skill, experience and scope of responsibilities, individual and business performance, economic climate and market conditions;<br>– the median market pay in the context of insurance peers and companies of a similar size, particularly FTSE 31-100 companies being companies which are considered to be reflective of the size and complexity of the Group; and<br>– general base salary movement across the Group.<br>• The Committee does not strictly follow data but uses it as a reference point in considering, in its judgement, the appropriate level having regard to other relevant factors including corporate and individual performance and any changes in an individual's role and responsibilities<br>• The principles for setting base salary are similar to those applied to other employees in the Group, although the specific benchmarking groups used to review external market relativities may differ across employee groups<br>• Base salary is paid monthly |
| **Annual Incentive Plan (the "AIP")** | • To motivate executives and incentivise delivery of performance over a one-year operating cycle, focusing on the short to medium-term elements of our strategic aims | • For Executive Directors, at least 40% of the award is deferred into shares under the Deferred Annual Incentive Plan (the "DAIP") typically vesting three years after grant (with deferred awards also capable of being settled in cash). The remainder of the award is paid in cash following year-end<br>• The percentage deferred and the terms of deferral will be kept under review by the Committee to ensure that levels are in line with regulatory requirements and best practice and may be changed in future years but will not, in the view of the Committee, be changed to be less onerous overall<br>• Malus and clawback provisions apply to both the cash and deferred elements and are explained in more detail in the notes to the policy table |
| **2012 Long-Term Incentive Plan (the "LTIP")** | • To motivate and incentivise delivery of sustained business performance over the long term, aligning executives' interests with those of shareholders<br>• To aid long-term retention of key executive talent | • Awards will typically be made in the form of nil-cost options or conditional share awards which vest to the extent performance conditions are satisfied over a period of at least three years. Under the Plan rules, awards may also be settled in cash<br>• Vested options will remain exercisable for a period of seven years<br>• Malus and clawback provisions apply to the LTIP and are explained in more detail in the notes to the policy table<br>• Awards under the LTIP may be made at various times during the financial year. While the Committee reserves the right to do otherwise, practice has been to make awards twice in each financial year following the announcement of the Group's annual and half-year results |

| Maximum opportunity | Performance measures |
|---|---|
| • The Committee has determined that its policy will be to only set base salaries by reference to the factors set out in the previous column for the duration of this policy. In any event no increase will be made if it would take an Executive Director's salary above the median level of salaries for relevant roles in the FTSE 100 as determined using data available to the Committee at or shortly prior to when any increase is considered<br>• Where salary increases are awarded, the Committee will have regard to the increase being awarded to employees within the Group more generally, as well as the other factors outlined in this table under 'Operation' | • Not applicable |
| • Maximum and target bonus levels for Executive Directors are set by reference to practice at other insurance and general market comparators<br>• The maximum bonus level potential under the AIP is 175% of base salary per annum. The current maximum bonus level applying for each individual Executive Director is shown in the statement of implementation of policy in 2015 section of the annual remuneration report | • Performance over the financial year is assessed against performance measures which the Committee considers to be appropriate<br>• These may be financial, non-financial (Group, divisional or business line) and individual. Each year, at least 50% of the bonus is based on financial measures. The remainder of the bonus will be based on a combination of non-financial and individual performance measures<br>• Targets are set at the beginning of each financial year by the Committee<br>• No more than 10% of the bonus is paid for threshold performance (30% for the individual performance element). No more than 60% of the maximum opportunity pays out for target performance. However, the Committee retains flexibility to amend the level of payout at different levels of performance for future bonus cycles based on its assessment of the level of stretch inherent in the targets that have been set and will disclose any such determinations appropriately<br>• Before any payment can be made, the Committee will perform an additional gateway assessment to determine whether the amount of any bonus is appropriate in view of such facts or circumstances as the Committee considers relevant. This assessment may result in moderation (either positive or negative) of each AIP performance measure but subject to the individual maximum bonus levels<br>• The AIP remains a discretionary arrangement and the Committee reserves discretion to adjust the out-turn (from zero to the cap) should it consider that to be appropriate. In particular, the Committee will operate this discretion as a gateway in respect of any risk concerns |
| • The Plan allows for awards over shares with an absolute maximum value of 200% of base salary per financial year (although awards of up to 300% of base salary are permitted in exceptional circumstances in relation to the recruitment or retention of an employee, as determined by the Remuneration Committee) | • The Committee will determine the performance conditions for each award made under the LTIP, with performance measured over a single period of at least three years with no provision to retest<br>• Performance is measured against targets set at the beginning of the performance period which may be set by reference to the time of grant or financial year<br>• Awards vest based on performance against financial and / or share return measures, as set by the Committee, to be aligned with the long-term strategic objectives of the Group<br>• For awards to be granted in 2015, vesting will continue to be determined based on two measures: RoTE and relative Total Shareholder Return ("**TSR**") performance against the FTSE 350 (excluding investment trusts). The Committee may apply different performance measures and targets in future years<br>• Awards will be subject to a payment gateway such that the Committee must be satisfied that there are no material risk failings, reputational concerns or regulatory issues<br>• In addition, there is an underpin relating to the Committee's view of the underlying financial performance of the Group<br>• Fuller details of the performance conditions and targets for 2015 and prior-year awards are set out in the annual remuneration report<br>• For both the TSR and RoTE elements, 20% of the award vests for threshold performance with 100% vesting for maximum performance. The Committee reserves the discretion to make changes to these levels which it considers non-material<br>• The Committee reserves the right to lengthen (but not reduce) any performance period and/ or to introduce a separate holding period |

| Element | Purpose and link to strategy | Operation |
|---|---|---|
| **Pension** | • To remain competitive within the market place<br>• To encourage retirement planning and retain flexibility for individuals | • Pension contributions are paid only in respect of base salary<br>• Executive Directors are eligible to participate in the defined contribution pension arrangement or alternatively they may choose to receive a cash allowance in lieu of pension<br>• This is in line with the approach taken for all Group employees |
| **Benefits** | • A comprehensive and flexible benefits package is offered, with the emphasis on individuals being able to choose the combination of cash and benefits that suits them | • Executive Directors receive a benefits package generally set by reference to market practice in companies of a similar size and complexity, particularly FTSE 31-100 companies. Benefits currently provided include a company car or car allowance, private medical insurance, life insurance, health screening and income protection<br>• The Committee may periodically amend the benefits available to employees. The Executive Directors are eligible to receive such additional benefits on similar terms to other senior executives<br>• In line with our approach to all employees, certain Group products are offered to Executive Directors at a discount<br>• Executive Directors are also eligible to participate in any of the employee share plans operated by the Company, in line with HMRC guidelines (where relevant), on the same basis as for other eligible employees. Currently this includes the Share Incentive Plan, which was also used to provide an award of free shares to all employees (including Executive Directors) at the time of the IPO |
| **Share ownership guidelines** | • To further align the interests of Executive Directors with those of shareholders | • Executive Directors are expected to retain all of the ordinary shares vesting under any of the Company's share incentive plans, after any disposals for the payment of applicable taxes, until they have achieved the required level of shareholding |

### Notes to the policy table

#### Stating maximum amounts for each element of remuneration

Where the table refers to the maximum amounts that may be paid in respect of any element of the policy (as required under the Regulations) these will operate simply as caps and not be indicative of any aspiration.

#### Malus and clawback

Malus (being the forfeiture of unvested awards) and clawback (being the ability of the Company to claim repayment of paid amounts) provisions apply to the AIP (cash and deferred element) and LTIP if, in the opinion of the Committee, any of the following has occurred:

- There has been a material misstatement of the Company's financial results which has led to an overpayment
- The assessment of performance targets is based on an error or inaccurate or misleading information or assumptions
- Circumstances warranting summary dismissal in the relevant period
- A material failure of risk management or any other act or omission that has had a sufficiently significant impact on the reputation of the Company to justify such action

Amounts in respect of awards under both plans may be subject to clawback for up to three years post payment or vesting as appropriate.

| Maximum opportunity | Performance measures |
|---|---|
| • Pension contributions for both Executive Directors are set at 25% of base salary per annum | • Not performance related |
| • The costs of benefits provided may fluctuate from year to year even if the level of provision has remained unchanged<br>• An annual limit of 10% of base salary per Executive Director has been set for the duration of this policy. The Committee will monitor the costs in practice and ensure that the overall costs do not increase by more than the Committee considers to be appropriate in all the circumstances<br>• In addition, the limit for any employee share plans in which the Executive Directors participate will be in line with the caps permitted by HMRC from time to time<br>• The Executive Directors may be entitled to retain fees received for any directorships held outside of the Group | • Not performance related |
| • 200% of salary for both Executive Directors (representing an increase from 150% in respect of the Chief Financial Officer)<br>• The Committee reserves the discretion to amend these levels in future years | • Not applicable |

### Exercise of discretion

In line with market practice, the Committee retains discretion in relation to the operation and administration of the AIP, DAIP and LTIP. This discretion includes, but is not limited to:

- The timing of awards and payments
- The size of awards, within the overall limits disclosed in the policy table
- The determination of vesting
- The treatment of awards in the case of change of control or restructuring
- The treatment of leavers within the rules of the plan and the termination policy summary shown on pages 90 to 91
- Adjustments needed in certain circumstances (for example, rights issue, corporate restructuring or special interim dividend)

The Committee also retains the discretion to amend the performance measures, weightings and targets after they have been set if events make it appropriate to do so. Any changes will be explained in future annual remuneration reports and, if appropriate, be the subject of consultation with the Company's major shareholders.

### Adjustment to number of shares under deferred bonus and LTIP

The number of shares subject to deferred bonus and LTIP awards may be increased to reflect the value of dividends that would have been paid in respect of any dates falling between the grant of awards and the date of vesting of awards (the date of transfer of shares for awards made prior to 2014).

The terms of incentive plan awards may be adjusted in the event of a variation of the Company's share capital, demerger or a similar event that materially affects the price of the shares or otherwise in accordance with the plan rules.

### Remuneration payments agreed prior to appointment to the Board

The Committee reserves the right to make any remuneration payments and payments for loss of office (including, where relevant, exercising any discretions available to it in connection with such payments) notwithstanding that they are not in line with the policy set out above where the terms of the payment were agreed (i) before the policy came into effect or (ii) at a time when the relevant individual was not a Director of the Direct Line Insurance Group plc and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a Director of the Company. For these purposes 'payments' include pension arrangements, the Committee satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are 'agreed' at the time the award is granted.

### RBS Legacy arrangements

Both Executive Directors continue to hold unvested awards previously granted to them under the RBS Group LTIP in 2012. These awards were granted to Paul Geddes and John Reizenstein at a time when they were divisional directors of RBS Group and will now be satisfied by the transfer of Direct Line Insurance Group plc shares from RBS Group on vesting. The performance conditions for these awards relate to financial and operational performance against the strategic plan for Direct Line Group, effective risk management and measures based on employee and customer satisfaction.

In addition, both Executive Directors continue to hold awards originally awarded under the RBS Group Deferral Plan and these will continue to be delivered in RBS Group shares. These awards are not subject to any performance conditions on vesting.

## Selection of performance measures

### Annual Incentive Plan

The AIP performance measures have been selected by the Committee to incentivise Executive Directors to achieve financial targets for the year as well as specific strategic and personal objectives. These measures are aligned with the key performance indicators that we use as a business to monitor performance against our strategic priorities, as shown on pages 26 to 27 of the Annual Report & Accounts.

The relevant targets are set at or following the start of each year to ensure that Executive Directors are appropriately focused on the key objectives for the next 12 months.

### Long-Term Incentive Plan

The ultimate goal of our strategy is to provide long-term sustainable returns for our shareholders.

For 2015, awards under the LTIP will therefore continue to be subject to performance against both RoTE and relative TSR targets, which are important KPIs for the business. The Committee believes that this combination provides a balanced approach to the measurement of Group performance over the longer term by using both a stated financial KPI that incentivises individuals to keep growing the business in an efficient way and a measure based on relative shareholder return. This combination of measures achieves an appropriate balance of absolute and relative returns.

## Differences in remuneration policy from broader employee population

When determining Executive Directors' remuneration, the Committee takes into account pay throughout the Group to ensure that the arrangements in place remain appropriate.

The Group has one consistent reward policy for all levels of employees. Therefore, the same reward principles guide reward decisions for all Group employees, including Executive Directors, although remuneration packages differ to take into account appropriate factors in different areas of the business:

- **AIP** – approximately 3,900 employees participate in the AIP and the corporate performance measures for all employees are consistent with those used for Executive Directors although the weighting attributable to those factors may differ. The Group's strategic leaders also receive part of their bonus in Company shares deferred for a period of three years
- **LTIP** – our strategic leaders participate in the LTIP currently based on the same performance conditions as those for Executive Directors, although the Committee reserves the discretion to vary the performance conditions for awards made to employees below the Board for future awards
- **All employee share plans** – the Committee considers it is important for all employees to have the opportunity to become shareholders in the Company. The HMRC-approved Buy-As-You-Earn Share Incentive Plan in the UK and an International plan mirroring the UK plan for Italy were both launched during 2013. At year-end, approximately 2,100 employees throughout the Group had signed up to these schemes

## Remuneration policy for Non-Executive Directors

| Element | Purpose and link to strategy | Approach to setting fees and cap | Other items |
|---|---|---|---|
| Chairman and Non-Executive Directors' fees | To enable the Company to recruit and retain Non-Executive Directors of the highest calibre, at the appropriate cost | • Non-Executive Directors are paid a basic annual fee plus reasonable travel expenses. Additional fees may be paid to Non-Executive Directors who chair a Board Committee, sit on a Board Committee and for the Senior Independent Director. The level of fees for 2015 is shown in the annual remuneration section<br>• Fee levels for Non-Executive Directors are reviewed and may be increased at appropriate intervals by the Board, with affected individual Directors absenting themselves from deliberations<br>• In setting the level of fees, the Company takes into account the expected time commitment of the role and fees at other companies of a similar size, sector and / or complexity to the Group<br>• The fees paid to the Chairman are inclusive of all Board and Committee membership fees and are determined by the Remuneration Committee<br>• Subject to a Non-Executive Director aggregate fee cap in the Articles of Association (currently £2,000,000 per annum), the Company reserves the right to change how the elements and weightings within the overall fees are paid and to pay a proportion of the fees in shares within this limit | • The Non-Executive Directors are not entitled to receive any compensation for loss of office, other than fees for their notice period. They do not participate in the Group's bonus, employee share plans or pension arrangements and do not receive any benefits |

### Recruitment remuneration policy

The recruitment remuneration policy aims to give the Committee sufficient flexibility to secure the appointment and promotion of high-calibre executives to strengthen the management team and secure the skill sets to deliver the Group's strategic aims.

### Principles for recruitment remuneration

- In terms of the principles for setting a package for a new Executive Director, the starting point for the Committee will be to look to the policy for Executive Directors as set out in the policy table and structure a package in accordance with that policy. Consistent with the Regulations, the caps contained within the policy table for fixed pay do not apply to new recruits, although the Committee would not envisage exceeding these caps in practice
- For an internal appointment, any variable pay element awarded in respect of the prior role may either continue on its original terms or be adjusted to reflect the new appointment, as appropriate
- For external and internal appointments (including a major change in role), the Committee may agree that the Company will meet certain relocation expenses, legal and other fees involved in negotiating any recruitment or pay expatriate benefits in line with the Group's international assignment policy, as appropriate

### Buy-out awards

- Where it is necessary to make a recruitment-related pay award to an external candidate, the Company will not pay more than is necessary, in the view of the Committee, and will in all cases seek, in the first instance, to deliver any such awards under the terms of the existing incentive pay structure
- All such awards for external appointments, whether under the AIP, LTIP or otherwise, to compensate for awards forfeited on leaving their previous employer will be capped at the commercial value of the amount forfeited and will take account of the nature, time horizons and performance requirements of those awards. In particular, the Committee's starting point will be to ensure that any awards being forfeited which remain subject to outstanding performance requirements (other than where substantially complete) are bought out with replacement requirements and any awards with service requirements are bought out with similar terms. However, exceptionally the Committee may relax those obligations where it considers it to be in the interests of shareholders and those factors are, in the view of the Committee, equally reflected in some other way, for example through a significant discount to the face value of the awards forfeited. It will only include guaranteed or non-prorated amounts under the AIP where the Committee considers that it is necessary to secure the recruitment

The elements of any package for a new recruit, including the maximum level of variable pay, but excluding buy-outs, and the approach taken by the Committee in relation to setting each element of the package will be consistent with the Executive Directors' remuneration policy described in this report, as modified by the above statement of principles where appropriate. The Committee reserves the right to avail itself of the current Listing Rule 9.4.2 if needed in order to facilitate, in exceptional circumstances, the recruitment of an Executive Director. Awards granted under this provision will only be used for buy-out awards.

Any commitments made before promotion to the Board (except when made in connection with the appointment to the Board) can continue to be honoured under the policy even if they are not consistent with the policy prevailing when the commitment is fulfilled.

In exceptional circumstances, the initial notice period may be longer than the Company's 12 month policy up to a maximum of 24 months. However, this will reduce by one month for every month served, until it has reduced to 12 months in line with the Company's policy position.

The remuneration policy for the Chairman and Non-Executive Directors as set out earlier in this report will apply in relation to any recruitments to those positions.

### Service contracts

Subject to the discretion noted above for new recruits, it is the Company's policy to set notice periods for Executive Directors of no more than 12 months (both by the Director or Company). The Executive Directors' service agreements summary is as follows:

| Director | Effective date of contract | Notice period (by Director or Company) | Exit payment policy |
|---|---|---|---|
| Paul Geddes | 1 September 2012 | 12 months | Base salary only for unexpired portion of notice period and to be paid in a lump sum or monthly instalments, in which case instalments are subject to mitigation if an alternative role is found. |
| John Reizenstein | 1 September 2012 | 12 months | Base salary only for unexpired portion of notice period and to be paid in a lump sum or monthly instalments, in which case instalments are subject to mitigation if an alternative role is found. |

There are no further obligations which could give rise to a remuneration or loss of office payment other than those set out in the remuneration policy table and termination policy summary.

### Termination policy summary

It is appropriate for the Committee to retain discretion to consider the termination terms of any Executive Director, having regard to all the relevant facts and circumstances available to them at the time. A Director is deemed a 'good leaver' if the following circumstances are met:

- Annual Incentive Plan and Long-Term Incentive Plan – death, injury, ill-health, redundancy, retirement, the sale of the individual's employing company or business out of the Group, or in such other circumstances as the Committee determines
- Deferred Annual Incentive Plan – for any reason other than summary dismissal or resignation unless, in the case of resignation only, the Committee determines otherwise

The table overleaf sets out the general position although it should be noted that the Committee, consistent with most other companies, has reserved a broad discretion to determine whether an Executive Director should be categorised as a 'good leaver' and that discretion forms part of the approved policy. Similarly, while the policy is generally to reduce AIP and LTIP awards on a pro-rata basis, the Committee has reserved discretion to disapply such reduction if, in the circumstances, it considers that to be appropriate taking into account the performance of the departing executive and the circumstances of leaving.

| Incentives | If a leaver is a 'bad leaver', for example leaving through resignation or summary dismissal | If a leaver is deemed to be a 'good leaver' | Other events, for example change in control or winding up of Company |
|---|---|---|---|
| Annual Incentive Plan | No awards made | Bonus paid at the normal time and on a time pro-rata basis, unless the Committee determines otherwise. | Bonus determined on such basis as the Committee considers appropriate and paid on a time pro-rata basis, unless the Committee determines otherwise. |
| Deferred Annual Incentive Plan | All awards will lapse | Deferred shares typically vest on the normal vesting date, although the Committee reserves discretion to accelerate vesting. In the case of the participant's death or other exceptional circumstances, awards may vest immediately. | Awards will vest in full.<br><br>In the event of a demerger or similar event, the Committee may determine that awards vest on the same basis. |
| Long-Term Incentive Plan | All awards will lapse | Awards will vest on the normal vesting date subject to performance and, unless the Committee determines otherwise, time pro rating. In exceptional circumstances, as determined by the Committee, for example in the case of the participant's death, awards may vest on cessation. | Awards will vest subject to the application of the performance conditions and, unless the Committee determines otherwise, time pro rating.<br><br>In the event of a demerger or similar event, the Committee may determine that awards vest on the same basis. |

Service agreements for Executive Directors provide that Paul Geddes and John Reizenstein are not eligible to receive any enhanced redundancy terms which may be offered by the Group from time to time. Their rights to a statutory redundancy payment are not affected.

Depending on the circumstances of departure, an Executive Director may have additional claims under relevant employment protection laws and the Company may contribute to any legal fees involved in agreeing a termination. It may also agree to incur certain other expenses such as the provision of outplacement services. Any such fees would be disclosed as part of the detail of any termination arrangements.

### Non-Executive Director letters of appointment

Non-Executive Directors are appointed for a three-year term which may be renewed by mutual agreement. In common with the Executive Directors, all Non-Executives are subject to annual re-election by shareholders.

The Directors may appoint additional members to join the Board during the year. Directors appointed in this way will be subject to election by shareholders at the first AGM after their appointment. In subsequent years the Directors are required to submit themselves for re-election at each AGM.

Terms and conditions of appointment of all of the Directors are available for inspection by any person at the Company's registered office and at the AGM.

The Chairman and Non-Executive Directors have notice periods of three months from either party, which do not apply in the case of a Director not being re-elected by shareholders or retiring from office under the articles of association. Other than fees for this notice period, the Chairman and Non-Executive Directors are not entitled to any compensation on exit.

### External directorships

The Company encourages Executive Directors to accept, subject to the approval of the Chairman, an invitation to join the board of another company outside the Group in a non-executive capacity, recognising the value of such wider experience. In these circumstances, they are permitted to retain any remuneration from the non-executive appointment. Executive Directors are generally limited to accepting one external directorship.

### Consideration of employment conditions elsewhere in the Group

As explained elsewhere in the Directors' remuneration report, the Committee reviews the overall pay and bonus decisions in aggregate for the wider Group and therefore takes account of pay and conditions in the wider Group in determining the Directors' remuneration policy and the remuneration payable to Directors. Through the Chief Executive Officer, Paul Geddes, and other senior management the Committee may receive input provided by employee groups within the Group, such as the Employee Representative Body, as required.

In accordance with prevailing commercial practice, the Committee did not consult with employees in preparing the Directors' remuneration policy.

### Consideration of shareholders' views

The Committee takes into account the approval levels of remuneration related matters at the AGM in determining whether the current Directors' remuneration policy remains appropriate.

The Committee, consistent with its approach of operating within the highest standards of corporate governance, takes significant account of guidelines issued by the ABI and shareholder bodies (such as the National Association of Pension Funds) when setting the remuneration policy.

The Committee will also seek to build an active and productive dialogue with investors on developments in the remuneration aspects of corporate governance generally and any changes to the Company's executive pay arrangements in particular.

The Committee is satisfied that no element of the Directors' remuneration policy conflicts with the Group's approach to environmental, social or corporate governance matters.

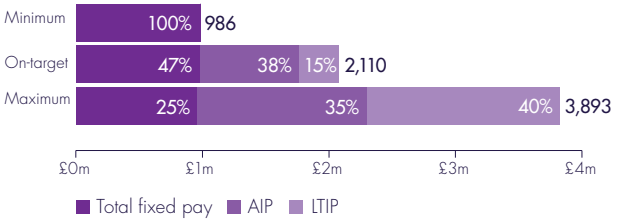
### Performance scenarios

The Directors' remuneration policy has been designed to ensure that a significant proportion of total remuneration is delivered in the form of variable pay and is therefore dependent on performance against our strategic objectives.

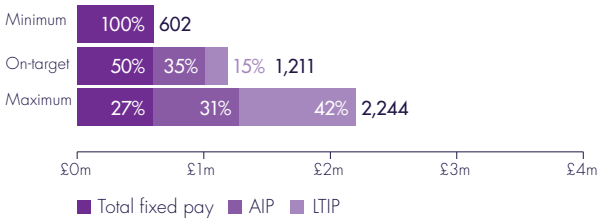
The Committee has considered the level of remuneration that may be paid under different performance scenarios to ensure that it would be appropriate in each situation in the context of the performance delivered and the value created for shareholders.

The following charts show the potential remuneration that may be earned by Executive Directors under three assumed performance scenarios as follows:

#### CEO – Paul Geddes
(£'000)




#### CFO – John Reizenstein
(£'000)



The elements of remuneration included in each scenario are as follows.

| | |
|---|---|
| **Minimum** | Consists of fixed remuneration only (that is, base salary, benefits and pension):<br>• Base salary is the salary to be paid from 1 April 2015<br>• Benefits measured as benefits paid in 2014 as set out in the single figure table on page 77<br>• Pension measured as the defined contribution or cash allowance in lieu of Company contributions, as a percentage of salary (25% of base salary for both Executive Directors) |
| **On-target** | Based on what the Director would receive if performance was on-target (excluding share price appreciation and dividends):<br>• Fixed remuneration as above<br>• AIP – consists of the on-target bonus of 60% of maximum bonus opportunity<br>• LTIP – consists of the threshold level of vesting (20% vesting) |
| **Maximum** | Based on the maximum remuneration receivable (excluding share price appreciation and dividends):<br>• Fixed remuneration as above<br>• AIP – consists of the maximum bonus (175% of base salary for Paul Geddes, 150% for John Reizenstein)<br>• LTIP – consists of the face value of awards (200% of base salary) |

The Directors present their report for the financial year ended 31 December 2014.

You can find the forward-looking statements disclaimer on page 171.

## Strategic report

The Company's Strategic report is on pages 2 to 49. It includes the following information that would otherwise be required to be disclosed in this Directors' report:

| Subject | Pages |
|---|---|
| Use of financial instruments | 47 |
| Important events since the financial year end | 10 to 13 |
| Likely future developments in the business | 13 and 36 to 39 |
| Employee involvement | 34 |

## Corporate governance statement

The FCA's Disclosure and Transparency Rules require certain information to be included in a corporate governance statement in the Directors' report. You can find information that fulfils the corporate governance statement's requirements in this Directors' report; the Corporate Governance report; the Committee reports; and the Directors' remuneration report on pages 50 to 93. This is incorporated into the Directors' report by reference.

## Disclosure of information under Listing Rule 9.8.4R

| Subject | Page |
|---|---|
| Contracts of significance | 95 |
| Details of shareholder dividend waivers | 95 |
| Significant shareholder agreements | 95 |

## Post-balance sheet events

Events after the balance sheet date are disclosed in note 40 to the consolidated financial statements.

## Dividends

Due to the uncertainty around the timing of the completion of the sale of the International division, and the potential related distribution, the Board has resolved to pay the 'final' dividend as an interim dividend.

The Board has therefore declared an interim dividend of 8.8 pence per share plus a second special interim dividend of 4.0 pence per share for the 2014 financial year. Both dividends will be paid on 17 April 2015 to all holders of Ordinary Shares on the register of members at close of business on 13 March 2015.

The Company paid an interim dividend of 4.4 pence per share, plus a special interim dividend of 10.0 pence per share in September 2014.

The special interim dividends are consistent with the Group's policy to distribute surplus capital.

Regarding 2013, the Company paid a final dividend of 8.4 pence per share and a special interim dividend of 4.0 pence per share in May 2014.

Including the dividends declared on 2 March 2015, the total dividend for the 2014 financial year is 27.2 pence per share (2013: 20.6 pence), of which 14.0 pence relates to special interim dividends (2013: 8.0 pence).

## Directors

You can find full biographical details of the current Directors on pages 52 to 53. All Directors will retire and be submitted for election or re-election at the 2015 AGM. This is in accordance with the UK Corporate Governance Code and the Articles of Association of the Company, governing appointment and replacement of directors.

Mark Catton resigned as a Director on 7 March 2014. His resignation followed the sale by RBS Group of substantially all of its shareholding in the Company in February 2014, as described further on page 68.

Sebastian James was appointed as a Director on 28 August 2014. You can find details on the appointment process in the Nomination Committee report on pages 68 to 69.

The powers of the Directors are set out in the Company's Articles of Association. You can obtain a copy of these on the Company's website at www.directlinegroup.com . The Directors' powers are also subject to relevant legislation and, in certain circumstances, authority given by the Company's shareholders.

## Directors' interests

You can find details of the Directors' remuneration, service contracts, employment contracts and interests in the shares of the Company in the Directors' remuneration report on pages 71 to 93.

## Directors' indemnities

The Articles of Association of the Company permit it to indemnify the officers of the Company, and the officers of any associated company, against liabilities arising from the conduct of Company business, to the extent permitted by law. Accordingly, the Company executed deeds of indemnity for the benefit of each Director regarding liabilities that may attach to them in their capacity as Directors of the Company or associated companies. These indemnities are qualifying third-party indemnities as defined by section 234 of the Companies Act 2006. No amount was paid under any of these indemnities during the year.

The Company maintains directors' and officers' liability insurance. This insurance provides appropriate cover for legal actions brought against its Directors.

The Company has also provided qualifying pension scheme indemnities to the directors of DLG Pension Trustee Limited in accordance with section 235 of the Companies Act 2006. DLG Pension Trustee Limited acts as trustee for two of the Company's occupational pension schemes.

## Share capital

The Company has a premium listing on the London Stock Exchange. As at 31 December 2014, its share capital comprised 1,500,000,000 fully paid Ordinary Shares of 10 pence each.

At the Company's 2014 AGM, the Directors were authorised to:

- allot shares in the Company up to an aggregate nominal amount of £50,000,000; or grant rights to subscribe for, or convert, any security into shares;
- allot shares up to an aggregate nominal amount of £100,000,000 for the purpose of a rights issue; and
- make market purchases up to 150,000,000 shares in the Company (representing approximately 10% of the Company's issued share capital at the time).

These authorities have not been used to date and shareholders will be asked to renew them at the 2015 AGM.

The Company has not held any shares in treasury during the period under review.

You can find further details of the Company's share capital and shares under option at 31 December 2014 in notes 27 and 33 to the consolidated financial statements.

The Company operates a share incentive plan for employees. Shares are held in this plan by a trustee on behalf of employees. The trustee may vote on the shares but has no obligation to do so. The trustee may also have regard to the participants' interests when exercising its voting rights.

## Rights attaching to shares

All of the Company's issued Ordinary Shares rank equally in all respects. The rights and obligations attaching to the Company's Ordinary Shares are set out in the Company's Articles of Association. You can obtain a copy of this on the Company's website at www.directlinegroup.com .

All issued shares are fully paid and free from any restrictions on their transfer, except where required by law, such as insider trading rules. All employees must conform to the Company's share dealing rules; these restrict the ability of particular employees to deal in the Company's shares at certain times and require permission to deal. Additionally, the relevant employee benefit trust must hold certain shares awarded under the Company's share plans for up to three years from the date of grant.

Where the trustees of the employee benefit trusts hold shares that have not been allocated to employees, they waive their entitlement to any dividends paid by the Company in respect of the unallocated shares they hold.

Further details on the number of shares held by the employee benefit trusts can be found in note 27 on page 148.

Each notice of general meeting will specify the time for determining a shareholder's entitlement to attend and vote at the meeting, which will not be more than 48 hours before the time fixed for the meeting. All proxy appointments must be filed at least 48 hours before the time of the meeting to be valid.

Where the Company has issued a notice under section 793 of the Companies Act 2006 which is in default for at least 14 days, the person(s) interested in those shares shall not be entitled to attend or vote at any general meeting until the default has been corrected or the shares sold.

## Articles of Association

Unless expressly specified to the contrary in the Articles of Association, they may only be amended by a special resolution of the Company's shareholders at a general meeting.

## Relationship Agreement with RBS Group

On 27 February 2014, RBS Group sold its remaining shareholding in Direct Line Insurance Group plc, except a small number of shares which it transferred to an employee benefit trust for the purpose of satisfying long-term incentive awards made by RBS Group to Direct Line Group's management during its period of ownership. As a consequence of selling its remaining shareholding, RBS Group relinquished its right, under the Relationship Agreement entered into on 16 October 2012, to nominate a Non-Executive Director to the Board. Accordingly, Mark Catton, the RBS Group nominated Non-Executive Director, stepped down from the Board on 7 March 2014. Direct Line Insurance Group plc is no longer owned by RBS Group and its operations are now largely separate.

Following the sale of RBS Group's shareholding in Direct Line Insurance Group plc, there is no arrangement or understanding with any shareholder, customer or supplier, or any other external party, providing the right to appoint a Director or a member of the Executive Committee, or any other special rights with regard to the control of Direct Line Insurance Group plc.

## Significant agreements affected by a change of control

A number of agreements may take effect, alter or terminate upon a change of control of the Company. None of these agreements is considered to be significant in terms of its impact on the business of the Group as a whole.

All of the Company's employee share incentive plans contain provisions relating to a change of control. Outstanding awards would typically vest and become exercisable. This is subject to satisfying any performance conditions, and normally with an additional time-based pro-rata reduction where performance conditions apply.

## Substantial shareholdings

In accordance with the provisions of chapter 5 of the FCA's Disclosure and Transparency Rules, the Company has been notified of the following direct and indirect interests in the Company's voting rights.

| | 31 December 2014 | 10 March 2015 |
|---|---|---|
| Blackrock Inc. | 5.08% | 5.08% |
| Schroders plc | 6.71% | 6.71% |

## Political donations

The Group made no political donations during the year (2013: nil).

## Employees with disabilities

As an organisation we are committed to ensuring that diversity is promoted across all areas of our business. At recruitment we make adjustments to facilitate applications and the selection process and provide guidance and where necessary additional training for interviewers.

Our Diversity Network Alliance has a 'strand' which focuses on matters important to our employees with a disability and to identify areas that we can improve upon. To facilitate continued employment we make reasonable adjustments to the working environment/equipment, the role or role requirements and ensure that the same opportunities are available to all.

## Greenhouse gas emissions

The Group has followed the 2013 UK Government environmental reporting guidance for greenhouse gas ("**GHG**") emissions, used the UK Government's greenhouse gas conversion factors, and adopted the financial control approach to setting the organisational boundaries of responsibilities for GHG emissions. GHG emissions are classified as direct or indirect, and divided into scope 1 and scope 2 emissions. Direct GHG emissions are those from sources that the Group owns or controls. Indirect GHG emissions are those that are a consequence of the Group's activities, but occur at sources owned or controlled by another organisation. The Group has considered the six main GHGs, reported in tonnes of carbon dioxide equivalent ("**$CO_2e$**"), and set 2013 as the base year. The Group has included emissions from all of its overseas subsidiaries. It has not included emissions associated with its investment portfolio.

- Scope 1 – direct emissions including fuels used in office buildings, accident repair centres and owned vehicles
- Scope 2 – indirect emissions resulting from generating electricity purchased for office buildings and accident repair centres

Total GHG emissions for continuing operations for 2014 were 27,308 tonnes (2013: 29,127 tonnes), as set out in the table below. This primarily comprised emissions from purchased electricity and natural gas, diesel fuel and refrigerant gas used.

In addition to total emissions, the Group also monitors emissions per £ million of net earned premium. In 2014, this was 9.1 tonnes per £ million of net earned premium for continuing operations (2013: 9.2 tonnes). This is a measure of how efficiently insurance products are provided and allows comparison between our year-on-year performance and performance against insurance companies.

Ecometrica has externally verified the GHG emissions data. Verification statements can be found on the Group's website at www.directlinegroup.com .

You can find further information on the Group's approach to energy and the environment in the Corporate Social Responsibility report on page 33.

## Greenhouse gas emissions

| $CO_2e$ tonnes | Continuing operations | | Total Group including International[1] | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Scope 1 direct | 7,784 | 8,423 | 7,787 | 8,424 |
| Scope 2 indirect | 19,524 | 20,704 | 20,972 | 22,200 |
| Total gross emissions | 27,308 | 29,127 | 28,759 | 30,624 |
| Emissions per £ million of net earned premium | 9.1 | 9.2 | 8.7 | 8.7 |

## Going concern

The Group has sufficient financial resources to meet its financial needs, including managing a mature portfolio of insurance risk. The Directors believe the Group is well positioned to manage its business risks successfully in the current economic environment.

The finance review on pages 40 to 49 describes the Group's capital management strategy, which covers how it measures its regulatory and economic capital needs, and deploys capital.

The Group's financial position is also covered in that section, including a commentary on cash and investment levels, reserves, currency management, insurance liability management, liquidity and borrowings. Additionally, note 3 to the consolidated financial statements describes capital management needs and policies and also covers underwriting, market, liquidity and credit risks which may affect the Group's financial position.

After making due enquiries, the Directors reasonably expect that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they have adopted the going concern basis in preparing the financial statements.

Note:

1. On 25 September 2014, the Group announced a binding agreement to sell its International division. This segment is now presented as discontinued operations.

## Disclosing information to the Auditor

Each Director at the date of the approval of this Annual Report & Accounts confirms that:

- so far as they are aware, there is no relevant audit information of which Deloitte LLP, the Company's external Auditor, is unaware; and
- they have taken all the steps they ought to have taken as a Director to make themselves aware of any relevant audit information and establish that Deloitte LLP 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.

## Auditor

Deloitte LLP has expressed its willingness to continue in office as the external Auditor. A resolution to reappoint Deloitte LLP will be proposed at the forthcoming AGM. An assessment of the effectiveness and recommendation for the reappointment of Deloitte LLP can be found in the Audit Committee report on page 63.

## Directors' responsibility statement

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare such financial statements for each financial year. Under that law, the Directors must prepare the Group financial statements in accordance with International Financial Reporting Standards ("**IFRSs**") as adopted by the EU and Article 4 of the International Accounting Standard ("**IAS**") regulation. They have also chosen to prepare the Parent Company financial statements under IFRSs, as adopted by the EU. Under company law, the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the Company's state of affairs and profit or loss for that period.

In preparing these financial statements, IAS 1 requires that Directors:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- assess the Company's ability to continue as a going concern.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclosing, with reasonable accuracy, the Company's financial position at any time, and enable them to ensure the financial statements comply with the Companies Act 2006. Additionally, they are responsible for safeguarding the Company's assets and hence taking reasonable steps to prevent and detect fraud and other irregularities. The Directors are responsible for maintaining and ensuring the integrity of the corporate and financial information included on the Company's website at www.directlinegroup.com . Legislation in the UK governing preparing and disseminating financial statements may differ from legislation in other jurisdictions.

Each of the Directors, whose names and functions are listed on pages 52 to 53, confirms that, to the best of their knowledge:

- the financial statements, prepared in accordance with IFRSs, give a true and fair view of the Company's assets, liabilities, financial position, and profit or loss, and the undertakings included in the consolidation taken as a whole; and
- the Strategic report (on pages 2 to 49) and Directors' report (on pages 94 to 97) include a fair review of the development and performance of the business, and the Company's position and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties they face.

## Statement of the Directors in respect of the Annual Report & Accounts

The Directors confirm that they consider that the Annual Report & Accounts, taken as a whole, are fair, balanced and understandable, and provide the information shareholders need to assess the Group's position and performance, business model and strategy.

In arriving at this conclusion, the Board was supported by a number of processes, including the following:

- management drafted the Annual Report & Accounts. To ensure consistency across sections, a steering group comprising a team of cross-functional senior management provided overall governance and co-ordination;
- a verification process to ensure the content was factually accurate;
- members of the Executive Committee reviewed drafts of the Annual Report & Accounts;
- the Company's Disclosure Committee reviewed an advanced draft, and the Company's legal advisers and Auditor reviewed certain parts; and
- the Audit Committee reviewed the substantially final draft before consideration by the Board.

A Committee of the Board reviewed and approved this report on 2 March 2015.

By order of the Board

**Roger C. Clifton**
Company Secretary
2 March 2015

## Financial statements

Independent auditor's report 99

## Consolidated financial statements

Consolidated income statement 103
Consolidated statement of comprehensive income 104
Consolidated balance sheet 105
Consolidated statement of changes in equity 106
Consolidated cash flow statement 107

## Notes to the consolidated financial statements

1. Accounting policies 108
2. Critical accounting estimates and judgements 115
3. Risk management 118
4. Segmental analysis 130
5. Discontinued operations and disposal group 133
6. Net earned premium 135
7. Investment return 135
8. Other operating income 136
9. Net insurance claims 136
10. Commission expenses 136
11. Operating expenses 136
12. Finance costs 138
13. Tax charge 138
14. Current and deferred tax 139
15. Dividends 140
16. Earnings and net assets per share, return on equity 140
17. Goodwill and other intangible assets 142
18. Property, plant and equipment 144
19. Investment property 144
20. Subsidiaries 145
21. Reinsurance assets 146
22. Deferred acquisition costs 146
23. Insurance and other receivables 146
24. Derivative financial instruments 147
25. Financial investments 147
26. Cash and cash equivalents and borrowings 147
27. Share capital 148
28. Other reserves 148
29. Subordinated liabilities 148
30. Insurance liabilities, unearned premium reserve and reinsurance assets 149
31. Life insurance liabilities and reinsurance assets 152
32. Retirement benefit obligations 152
33. Share-based payments 154
34. Trade and other payables including insurance payables 156
35. Notes to the consolidated cash flow statement 157
36. Contingent liabilities 157
37. Commitments 158
38. Fair value 159
39. Related parties 160
40. Post balance sheet events 160

## Parent Company financial statements

Parent Company balance sheet 161
Parent Company statement of comprehensive income 162
Parent Company statement of changes in equity 162
Parent Company cash flow statement 162

## Notes to the Parent Company financial statements

1. Accounting policies 163
2. Investment in subsidiary undertakings 163
3. Asset held for sale 163
4. Other receivables 164
5. Current tax assets 164
6. Derivative financial instruments 164
7. Financial investments 164
8. Cash and cash equivalents 164
9. Share capital 164
10. Subordinated liabilities 165
11. Trade and other payables 165
12. Dividends 165
13. Cash generated from operations 165
14. Related parties 166
15. Share-based payments 166
16. Risk management 166
17. Directors and key management remuneration 166

## Opinion on the financial statements of Direct Line Insurance Group plc

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2014 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("**IFRSs**") as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the International Accounting Standard ("**IAS**") Regulation.

The financial statements comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated and Parent Company balance sheets, the consolidated and Parent Company cash flow statements, the consolidated and Parent Company statements of changes in equity and the related notes 1 to 40 on the consolidated financial statements, and the related notes 1 to 17 on the Parent Company financial statements. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

## Separate opinion in relation to IFRSs as issued by the IASB

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

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

## Going concern

As required by the Listing Rules we have reviewed the Directors' statement on page 96 that the Group is a going concern. We confirm that:

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

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

## Our assessment of risks of material misstatement

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

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **The methodology and assumptions used in setting insurance reserves**<br>Insurance reserves include the Group's insurance liabilities from continuing business totalling £4.7 billion as detailed in note 30, and the insurance liabilities held for sale, in relation to the International operations, totalling £553.4 million as detailed in note 5. The determination of the value of the insurance reserves requires significant judgment in the selection of key assumptions and methodologies. Management exercises significant judgement in respect of the trends in bodily injury claims frequency and severity, the propensity for large claims to settle as periodic payment orders ("**PPOs**"), the likely outcome of the government's consultation on the Ogden discount rate used by the courts to calculate claims for long-term damages and other regulatory developments. | We have tested the design and implementation and operating effectiveness of the key controls over the end-to-end reserving process. We also tested the completeness and accuracy of the underlying data used in the actuarial calculations through performing reconciliations on the data back to the financial ledger and the actuarial data used by our Deloitte actuarial specialists.<br><br>Having done this, we worked with those specialists to:<br>• consider the suitability of the methodology used in setting insurance reserves;<br>• challenge management's key assumptions and judgements against industry benchmark; and<br>• assess whether the reserving methodology has been applied consistently across periods.<br><br>We also performed work to understand the sensitivity of insurance reserves to changes in key assumptions and methodology. |

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **The valuation of investments including complex financial instruments and their accounting treatment in accordance with IAS 39 and IFRS 13**<br>The Group's financial investments shown in notes 25 and 19 represent the largest number on the balance sheet, £6.3 billion. The Group's investment portfolio has become more diversified with introduction of an infrastructure debt portfolio during 2014. The valuation of financial investments held at fair value is based on a range of inputs. Many of the inputs required can be obtained from readily available liquid market prices and rates. Where observable market data is not available, for example, when determining the valuation of investment property, estimates must be developed based on the most appropriate source data and are subject to significant judgement. | We have performed audit procedures over the valuation and accounting of investments held by the Group. We have tested the design and implementation and operating effectiveness of the key controls over the investment valuation process. On a sample basis we have tested their valuation at the year end. We also performed a review of sources and systems used by the Group for valuation and compared valuations to those obtained from an independent source using various data points where there was a degree of subjectivity. We have reviewed the classification and accounting treatment of the Group's investment portfolio in line with the accounting polices set out in note 1.12 to the consolidated financial statements. We also have used our financial instrument valuation specialists, where appropriate, to test the valuation of complex financial instruments, such as derivatives and compliance with the hedge accounting rules. We have checked that the Group's disclosures satisfied the requirements of IAS 39, IFRS 7 and IFRS 13. |
| **IT server migration**<br>Towards the end of 2014, the Group began its program of transitioning onto new IT servers independent from RBS Group infrastructure. There is a risk with a large and complex migration of this nature of data loss and significant business interruption. There is also a risk that the controls surrounding the new servers are inadequate. | We have tested the design and implementation and operating effectiveness of general IT controls around key IT processes on the migrated applications and infrastructure, and have understood the governance process over the IT migration itself. We have tested the Group's reconciliation of key financial data pre- and post-migration to check the completeness and accuracy of the data migrated. |
| **Transformation projects**<br>There is a risk that the business transformation programmes undertaken by the Group could impact the internal financial reporting control environment, in particular, in areas of the business where there has been significant headcount reduction or new processes and procedures have been introduced. There is a risk that there may no longer be an appropriate level of review or adequate segregation of duties. | We have tested the design and implementation and operating effectiveness of key business processes that have been subject to change. We have tested the processes to determine whether appropriate segregation of duties continues to exist within the Group's system of internal controls. For example, our procedures included an assessment of the impact to the control environment and processes from the wider implementation of the new claims system in the Commercial division. |
| **Reinsurance asset valuation**<br>The valuation of the reinsurance asset in respect of the ceded part of the insurance reserves, as detailed in note 21, requires significant judgement to reflect the credit risk exposure to long-term assets arising from PPOs. | We have tested the design and implementation and operating effectiveness of the key controls over the reinsurance asset measurement and valuation process.<br><br>We have challenged management's key assumptions over credit risk and the calculation methodology, including a comparison of the underlying credit ratings for key reinsurance counterparties to independent sources. We have also considered the consistency of the approach with the prior year. |
| **Revenue recognition**<br>Due to the large number of policies underwritten by the Group there is a risk that the revenue recorded in the financial statements and the flow of premium information from the underwriting systems to the financial reporting ledger is not complete and accurate. | We have tested the design and implementation and operating effectiveness of the key controls over revenue recognition, focusing on the flow of information from the underwriting systems to the financial reporting ledger. In addition, we performed substantive analytical testing procedures on the gross and unearned premium balances. |

The Audit Committee's consideration of these risks is set out on page 61.

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

## Our application of materiality

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

We have determined that the critical benchmark for the Group was average pre-tax profit from ongoing operations. This measure uses a three-year average of profit before tax, excluding the impact of discontinued activities and transformation costs to exclude the effect of year-on-year volatility. We calculated materiality for the Group to be £28 million (2013: £40 million), which is below 6.5% (2013: 8.48%) of average pre-tax profit from ongoing operations. We also considered this measure to be suitable having compared to other benchmarks: our materiality is 5.86% of statutory profit before tax, 0.76% of gross earned premium and below 1.5% of equity. Our materiality is lower than the level we set for the year ended 31 December 2013 to reflect: the disposal of the Group's International business, with a consequential reduction in profit and premium income; emerging market practice; and guidance issued by the Financial Reporting Council. Group materiality is used for setting audit scope and the assessment of uncorrected misstatements. Component materialities are set for work on significant components – audit testing for the main UK insurance trading entity, which makes up 88% of Group revenue and 85% of Group statutory profit before tax, is performed at component materiality of £25.1 million (2013: £25.5 million).

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £560,000 (2013: £800,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

## An overview of the scope of our audit

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

Four entities at these locations were subject to a full audit, a further two were subject to an audit of specified account balances where the extent of our testing was based on our assessment of the risks of material misstatement and of the materiality of the Group's operations at those locations.

These six entities represent the principal business units and account for 98% (2013: 98%) of the Group's net assets, 99% (2013: 99%) of the Group's revenue and 95% (2013: 95%) of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above.

Our audit work at the three locations was executed at levels of materiality applicable to each individual entity which were lower than Group materiality.

At the parent entity level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specified account balances. The Group audit team also performs the audit of the UK entities which account for 93% of the Group's net assets and 94% of the Group's profit before tax.

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

## Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

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

## Matters on which we are required to report by exception

### Adequacy of explanations received and accounting records

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

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

We have nothing to report in respect of these matters.

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

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

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

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

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

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

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

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

**David Rush FCA (Senior Statutory Auditor)**
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
2 March 2015

## Consolidated income statement
For the year ended 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Continuing operations** | | | |
| Gross earned premium | 6 | **3,144.2** | 3,317.0 |
| Reinsurance premium ceded | 6 | **(157.5)** | (160.2) |
| **Net earned premium** | 6 | **2,986.7** | 3,156.8 |
| Investment return | 7 | **215.1** | 197.7 |
| Instalment income | | **100.4** | 111.0 |
| Other operating income | 8 | **46.9** | 61.6 |
| **Total income** | | **3,349.1** | 3,527.1 |
| Insurance claims | 9 | **(1,778.6)** | (1,881.8) |
| Insurance claims recoverable from reinsurers | 9 | **51.2** | 10.9 |
| **Net insurance claims** | 9 | **(1,727.4)** | (1,870.9) |
| Commission expenses | 10 | **(354.0)** | (334.5) |
| Operating expenses | 11 | **(776.0)** | (888.7) |
| **Total expenses** | | **(1,130.0)** | (1,223.2) |
| **Operating profit** | | **491.7** | 433.0 |
| Finance costs | 12 | **(37.2)** | (37.7) |
| Gain on disposal of subsidiaries | 20 | **2.3** | 12.0 |
| **Profit before tax** | | **456.8** | 407.3 |
| Tax charge | 13 | **(97.5)** | (96.5) |
| Profit from continuing operations, net of tax | | **359.3** | 310.8 |
| Profit from discontinued operations, net of tax | 5 | **13.3** | 2.0 |
| **Profit for the year attributable to owners of the Company** | | **372.6** | 312.8 |
| | | | |
| **Earnings per share:** | | | |
| Continuing operations: | | | |
| Basic (pence) | 16 | **24.0** | 20.8 |
| Diluted (pence) | 16 | **23.8** | 20.7 |
| Continuing and discontinued operations: | | | |
| Basic (pence) | 16 | **24.9** | 20.9 |
| Diluted (pence) | 16 | **24.7** | 20.8 |

The attached notes on pages 108 to 160 form an integral part of these consolidated financial statements.

## Consolidated statement of comprehensive income
For the year ended 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Profit for the year** | | **372.6** | 312.8 |
| **Other comprehensive income / (loss)** | | | |
| **Items that will not be reclassified subsequently to the income statement:** | | | |
| Actuarial gain / (loss) on defined benefit pension scheme | 32 | **2.8** | (6.9) |
| Tax relating to items that will not be reclassified | | **(0.6)** | 1.5 |
| | | **2.2** | (5.4) |
| **Items that may be reclassified subsequently to the income statement:** | | | |
| Exchange differences on translation of foreign operations | | **(14.5)** | (4.9) |
| Cash flow hedges | | **1.3** | – |
| Fair value gain / (loss) on available-for-sale investments | 28 | **97.2** | (108.2) |
| Less: realised net gains on available-for-sale investments included in income statement | 28 | **(22.8)** | (25.7) |
| Tax relating to items that may be reclassified | | **(17.6)** | 33.9 |
| | | **43.6** | (104.9) |
| **Other comprehensive income / (loss) for the year net of tax** | | **45.8** | (110.3) |
| **Total comprehensive income for the year attributable to owners of the Company** | | **418.4** | 202.5 |

The attached notes on pages 108 to 160 form an integral part of these consolidated financial statements.

## Consolidated balance sheet
As at 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Assets** | | | |
| Goodwill and other intangible assets | 17 | 517.5 | 500.1 |
| Property, plant and equipment | 18 | 181.3 | 102.3 |
| Investment property | 19 | 307.2 | 223.4 |
| Reinsurance assets | 21 | 862.5 | 1,011.0 |
| Deferred tax assets | 14 | – | 19.3 |
| Current tax assets | 14 | 0.1 | 1.3 |
| Deferred acquisition costs | 22 | 208.4 | 321.5 |
| Insurance and other receivables | 23 | 959.9 | 1,122.0 |
| Prepayments, accrued income and other assets | | 107.9 | 95.7 |
| Derivative financial instruments | 24 | 27.3 | 40.7 |
| Retirement benefit asset | 32 | 3.5 | – |
| Financial investments | 25 | 5,961.2 | 7,441.2 |
| Cash and cash equivalents | 26 | 880.4 | 908.3 |
| Assets held for sale | 5 | 1,208.4 | 1.0 |
| **Total assets** | | 11,225.6 | 11,787.8 |
| **Equity** | | 2,810.5 | 2,790.0 |
| **Liabilities** | | | |
| Subordinated liabilities | 29 | 526.3 | 486.6 |
| Insurance liabilities | 30 | 4,674.1 | 5,757.4 |
| Unearned premium reserve | 30 | 1,434.2 | 1,818.7 |
| Retirement benefit obligations | 32 | – | 2.0 |
| Borrowings | 26 | 69.8 | 55.1 |
| Derivative financial instruments | 24 | 29.4 | 19.3 |
| Trade and other payables including insurance payables | 34 | 660.6 | 818.3 |
| Deferred tax liabilities | 14 | 20.6 | 19.3 |
| Current tax liabilities | 14 | 35.7 | 21.1 |
| Liabilities held for sale | 5 | 964.4 | – |
| **Total liabilities** | | 8,415.1 | 8,997.8 |
| **Total equity and liabilities** | | 11,225.6 | 11,787.8 |

The attached notes on pages 108 to 160 form an integral part of these consolidated financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 2 March 2015. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

## Consolidated statement of changes in equity
For the year ended 31 December 2014

| | Notes | Share capital £m | Employee trust shares £m | Capital reserves £m | Revaluation reserve £m | Non-distributable reserve £m | Foreign exchange translation reserve £m | Retained earnings £m | Total shareholders equity £m |
|---|---|---|---|---|---|---|---|---|---|
| **Balance at 1 January 2013** | | 150.0 | (5.0) | 1,450.0 | 158.8 | 63.2 | 5.0 | 1,009.6 | 2,831.6 |
| Profit for the year | | – | – | – | – | – | – | 312.8 | 312.8 |
| Other comprehensive loss | | – | – | – | (100.0) | – | (4.9) | (5.4) | (110.3) |
| Dividends | 15 | – | – | – | – | – | – | (242.7) | (242.7) |
| Transfer to non-distributable reserve | 28 | – | – | – | – | 29.6 | – | (29.6) | – |
| Shares acquired by employee trusts | | – | (5.7) | – | – | – | – | – | (5.7) |
| Credit to equity for equity-settled share-based payments | 33 | – | – | – | – | – | – | 4.1 | 4.1 |
| Shares distributed by employee trusts | | – | 0.5 | – | – | – | – | (0.5) | – |
| Deferred tax on share-based payments | 14 | – | – | – | – | – | – | 0.2 | 0.2 |
| **Balance at 31 December 2013** | | 150.0 | (10.2) | 1,450.0 | 58.8 | 92.8 | 0.1 | 1,048.5 | 2,790.0 |
| Profit for the year | | – | – | – | – | – | – | 372.6 | 372.6 |
| Other comprehensive income | | – | – | – | 56.8 | – | (13.2) | 2.2 | 45.8 |
| Dividends | 15 | – | – | – | – | – | – | (401.1) | (401.1) |
| Transfer to non-distributable reserve | 28 | – | – | – | – | 32.1 | – | (32.1) | – |
| Shares acquired by employee trusts | | – | (4.4) | – | – | – | – | – | (4.4) |
| Credit to equity for equity-settled share-based payments | 33 | – | – | – | – | – | – | 6.6 | 6.6 |
| Shares distributed by employee trusts | | – | 1.0 | – | – | – | – | (1.0) | – |
| Deferred tax on share-based payments | 14 | – | – | – | – | – | – | 1.0 | 1.0 |
| **Balance at 31 December 2014** | | 150.0 | (13.6) | 1,450.0 | 115.6 | 124.9 | (13.1) | 996.7 | 2,810.5 |

The attached notes on pages 108 to 160 form an integral part of these consolidated financial statements.

## Consolidated cash flow statement
For the year ended 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Net cash used by operating activities before investment of insurance assets** | 35 | **(410.6)** | (307.0) |
| Cash generated from investment of insurance assets | 35 | **1,121.1** | 433.0 |
| **Net cash generated from operating activities** | | **710.5** | 126.0 |
| **Cash flows from investing activities** | | | |
| Purchases of property, plant and equipment | 18 | **(86.7)** | (39.1) |
| Purchases of intangible assets | 17 | **(92.8)** | (115.5) |
| Purchases of asset held for sale | | **(12.6)** | – |
| Proceeds on disposals of asset held for sale | | **0.8** | – |
| Net cash flows from acquisition / disposal of subsidiaries | 20 | **(24.7)** | 18.8 |
| Cash flows from net investment hedges | | **–** | (9.5) |
| **Net cash used by investing activities** | | **(216.0)** | (145.3) |
| **Cash flows from financing activities** | | | |
| Dividends paid | 15 | **(401.1)** | (242.7) |
| Repayment of subordinated liabilities | | **–** | (258.5) |
| Finance costs | | **(37.9)** | (37.8) |
| Purchase of employee trust shares | | **(4.4)** | (5.7) |
| **Net cash used by financing activities** | | **(443.4)** | (544.7) |
| **Net increase / (decrease) in cash and cash equivalents** | | **51.1** | (564.0) |
| Cash and cash equivalents at the beginning of the year | | **853.2** | 1,417.5 |
| Effect of foreign exchange rate changes | | **(6.1)** | (0.3) |
| **Cash and cash equivalents at the end of the year** | 26 | **898.2** | 853.2 |

The attached notes on pages 108 to 160 form an integral part of these consolidated financial statements.

## Corporate information

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

## 1. Accounting policies

### Basis of preparation

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

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

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

The International segment has been classified as a discontinued operation; accordingly the income statement has been re-presented in respect of the prior period and International assets and liabilities have been presented as a disposal group.

### Adoption of new and revised standards

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

IAS 19 (amended), 'Employee Benefits'. Introduces a narrow-scope amendment, to simplify the accounting for employee contributions in respect of defined benefit plans that are independent of the number of years of service.

IAS 32 (amended), 'Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities'. These amendments address previous inconsistencies when applying the offsetting criteria in IAS 32.

IAS 36 (amended), 'Impairment of Assets – Recoverable Amount Disclosures for Non-Financial Assets'. These amendments clarify the scope of certain disclosures around the recoverable amount of impaired assets.

IAS 39 (amended), 'Financial Instruments: Recognition and Measurement'. These amendments provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria.

IFRS 10, IFRS 12 and IAS 27 (amended), 'Investment Entities'. These amendments define an exception to consolidating particular subsidiaries for investment entities.

IFRIC 21, 'Levies'. Clarifies how an entity should account for liabilities to pay levies imposed by governments.

### 1.1 Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and the entities that are controlled by the Group at 31 December 2014 and 31 December 2013. Control exists when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. In assessing if the Group controls another entity, the existence and effect of the potential voting rights that are currently exercisable or convertible are considered.

Where necessary, adjustments have been made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. The policies set out below have been applied consistently throughout the years ended 31 December 2014 and 31 December 2013 to items considered material to the consolidated financial statements.

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

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

### 1.2 Foreign currencies

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

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

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

### 1.3 Contract classification

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

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

### 1.4 Revenue recognition

*Premiums earned*

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

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

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

*Investment return*

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

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

*Instalment income*

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

*Other operating income*

Vehicle replacement referral income

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

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

Revenue from vehicle recovery and repair services

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

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

Other income

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

Legal services revenue represents the amount charged to clients for professional services provided during the year including expenses but excluding value added tax. Revenue is only recognised once services have been provided and certainty exists as to the outcome of the respective cases.

### 1.5 Insurance claims

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

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

## 1. Accounting policies continued

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

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

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

### 1.6 Reinsurance

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

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

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

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

### 1.7 Deferred acquisition costs

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

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

### 1.8 Goodwill and other intangible assets

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

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

| | |
|---|---|
| Software development costs | 5 years |

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

### 1.9 Property, plant and equipment

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

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

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

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

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

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

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

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

### 1.11 Investment property

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

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

### 1.12 Financial assets

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

*AFS*

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

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

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

The valuation methodology described above uses observable market data.

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

## 1. Accounting policies continued

*Loans and receivables*

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

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

Receivables also include amounts due in respect of the provision of legal services.

### Impairment of financial assets

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

*AFS*

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

*Loans and receivables*

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

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

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

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

### Derivatives and hedging

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

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

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

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

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

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

### Derecognition of financial assets

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

### 1.13 Cash and cash equivalents

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

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

### 1.14 Financial liabilities

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

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

### 1.15 Subordinated liabilities

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

### 1.16 Provisions

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

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

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

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

### 1.17 Leases

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

### 1.18 Pensions and other post-retirement benefits

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

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

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

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

### 1.19 Taxation

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

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

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

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

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

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

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

## 1. Accounting policies continued

### 1.20 Share-based payments

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

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

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

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

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

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

### 1.21 Capital instruments

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

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

### 1.22 Dividends

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

### 1.23 Accounting developments

In July 2014, the IASB issued IFRS 9 'Financial Instruments' that will replace IAS 39 'Financial instruments: Recognition and Measurement' in its entirety. The classification and measurement of financial assets and liabilities will be directly linked to the nature of the instrument's contractual cash flows and the business model employed by the holder of the instrument.

The standard introduces a new expected loss model that is a departure from the current incurred loss model. The model requires a 12 month expected loss to be recognised for all financial instruments when they first originate or are acquired. In subsequent periods, if there is a significant increase in credit risk of a financial instrument since it was originated or acquired, the full lifetime expected credit loss would then be recognised.

The standard has introduced greater flexibility in the type of transactions eligible for hedge accounting and broadened the type of instruments that qualify as hedging instruments. The hedge effectiveness test has been replaced with the principle of an 'economic relationship'.

The standard is effective for annual periods beginning on or after 1 January 2018, although early adoption is permitted.

In May 2014, IFRS 15 'Revenue from Contracts with Customers' was issued by the IASB, to establish a single comprehensive model to use in accounting for revenue recognition and measurement, from contracts (note: insurance contracts are excluded from the scope of IFRS 15) with customers. The standard provides guidance on when and how combined contracts should be unbundled and when a transaction price includes a variable consideration element. The standard will require the Group to consider contracts with customers to determine if changes are required to existing accounting practices, but is not expected to have a material impact on the Group's financial statements.

The standard is effective for annual periods beginning on or after 1 January 2017, although early adoption is permitted.

## 2. Critical accounting estimates and judgements

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial information. The Group's principal accounting policies are set out on pages 108 to 114. UK company law and IFRSs require the Directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent.

In the absence of an applicable standard or interpretation, IAS 8 requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of Financial Statements. The judgements and assumptions involved in the Group's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.

### 2.1 General insurance: outstanding claims provisions and related reinsurance recoveries

The Group makes provision for the full cost of outstanding claims from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and claims handling. Outstanding claims provisions net of related reinsurance recoveries at 31 December 2014 amounted to £3,898.6 million with an additional £393.5 million included in liabilities held for sale (2013: £4,840.1 million).

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

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

In August 2012, the MoJ announced a review of the approach to setting the Ogden discount rate within the existing legal framework. Following further consultation, in 2014 the Justice Secretary announced that a panel of three financial investment experts will be appointed to provide testimony on potential changes to the discount rate on personal injury damages.

The Group holds provisions for a reduction in the Ogden discount rate at 31 December 2014 to 1.5% (2013: 1.5%). Details of sensitivity analysis to the assumed Ogden discount rate are shown in note 3.3.1.

The Group settles some large bodily injury claims as PPO's rather than lump sum payments.

The table below analyses the outstanding PPO claims provisions on a discounted and an undiscounted basis at 31 December 2014 and 31 December 2013. These represent the total cost of PPOs rather than any costs in excess of purely Ogden-based settlement.

| At 31 December | Discounted 2014 £m | Undiscounted 2014 £m | Discounted 2013 £m | Undiscounted 2013 £m |
|---|---|---|---|---|
| **Gross claims** | | | | |
| Approved PPO claims provisions | 422.6 | 1,245.7 | 367.7 | 1,099.9 |
| Anticipated PPOs | 651.0 | 1,963.2 | 631.2 | 1,935.7 |
| **Total** | 1,073.6 | 3,208.9 | 998.9 | 3,035.6 |
| **Reinsurance** | | | | |
| Approved PPO claims provisions | (216.6) | (688.6) | (204.9) | (656.3) |
| Anticipated PPOs | (216.5) | (839.6) | (165.9) | (707.9) |
| **Total** | (433.1) | (1,528.2) | (370.8) | (1,364.2) |
| **Net of reinsurance** | | | | |
| Approved PPO claims provisions | 206.0 | 557.1 | 162.8 | 443.6 |
| Anticipated PPOs | 434.5 | 1,123.6 | 465.3 | 1,227.8 |
| **Total** | 640.5 | 1,680.7 | 628.1 | 1,671.4 |

## 2. Critical accounting estimates and judgements continued

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

In the majority of cases, the inflation agreed in the settlement is the Annual Survey of Hours and Earnings SOC 6115 inflation published by the Office for National Statistics, for which the long-term rate is assumed to be 4.0% (2013: 4.0%). The rate of interest used for the calculation of present values is 4.0% (2013: 4.0%), which results in a real discount rate of 0.0% (2013: 0.0%). Since lump sum payments are calculated using a real discount rate of 2.5% (2013: 2.5%) the PPOs reserved cost is greater than that of lump sum settlements.

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

### 2.2 Impairment provisions – financial assets

#### AFS

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

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

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

Impairment provision on AFS financial assets in the year ended 31 December 2014 amounted to a £1.3 million release (2013: £nil).

Had all the declines in AFS asset values met the criteria above at 31 December 2014, the Group would suffer a further £15.8 million loss of which £0.3 million relates to the disposal group (2013: £40.4 million loss), being the transfer of the total AFS reserve for unrealised losses to the income statement. These movements represent mark-to-market movements and where there is no objective evidence of any loss events that could affect future cash flows, no impairments are recorded for these movements.

## 2.3 Fair value

Financial assets classified as AFS debt securities and derivative financial instruments are recognised in the financial statements at fair value determined using observable market input. The fair value of AFS debt securities at 31 December 2014 amounted to £5,830.3 million with an additional £706.9 million included in assets held for sale (2013: £7,005.5 million). The fair value of derivative financial assets and liabilities amounted to £27.3 million (2013: £40.7 million) and £29.4 million (2013: £19.3 million) respectively.

Freehold and long leasehold properties that are classified as investment properties are recognised in the financial statements at fair value. The fair value at 31 December 2014 amounted to £307.2 million (2013: £223.4 million) and was determined using a valuation model that includes inputs that are unobservable.

### Estimation of the fair value of assets and liabilities

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

#### Financial assets and liabilities

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

#### Investment property

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

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

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

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

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

## 2.4 Deferred acquisition costs

The Group defers a proportion of acquisition costs incurred during the year to subsequent accounting periods. Management use estimation techniques to determine the level of costs to be deferred, by category of business. Judgement is used to determine the types of cost that can be deferred and these are referred to in note 1.7. The total deferred acquisition costs at 31 December 2014 amounted to £208.4 million with an additional £111.1 million included in assets held for sale (2013: £321.5 million). During 2014, the Group reviewed these costs included in the calculation of deferred acquisition costs and considers them to be appropriate, and has determined that they are recoverable.

## 2.5 Goodwill

The Group capitalises goodwill arising on the acquisition of businesses as discussed in note 1.8. The carrying value of goodwill at 31 December 2014 was £211.0 million (2013: £211.0 million).

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

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

## 2. Critical accounting estimates and judgements continued

Impairment testing inherently involves a number of judgemental areas: the preparation of the five-year strategic plan and the extrapolation of cash flow forecasts beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of CGUs; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details of a sensitivity analysis on the recoverable amount in excess of carrying value are shown in note 17.

### 2.6 Property, plant and equipment

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

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

## 3. Risk management

### 3.1 Enterprise-wide Risk Management framework

The ERM framework within the Group is designed to ensure that risk management is a forward-looking discipline, focused on facilitating appropriate and fair outcomes on a consistent and reliable basis for all stakeholders. The ERM process provides the Group with a consistent and holistic view of risk management. Further information can be found in the Risk management section of the Strategic report on page 28.

### 3.2 Risk and capital management modelling

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

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

### 3.3 Principal risks from insurance activities and use of financial instruments

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

#### 3.3.1 Insurance risk

The Group is exposed to insurance risk as a primary consequence of its business. Key insurance risks focus on the inherent uncertainty around the occurrence, amount and timing of insurance liabilities arising through risks accepted during insurance operations, as defined in the ERM framework.

The insurance risks that the Group faces include those referred to below;

##### Reserving risk

Reserving risk relates to both premiums and claims. The risk that technical reserves are incorrectly assessed such that inappropriate funds have been retained to handle and pay claims and associated expenses as the amounts fall due, or that a surplus of funds has been retained resulting in opportunity costs.

Reserving risk is controlled through a range of processes:

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

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

Uncertainty in claims reserve estimation is larger for claims such as PPOs for which annually indexed payments are made typically over the lifetime of the injured party. Claims reserves for PPOs are held on a discounted basis and are sensitive to a change in the discount rate.

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

| | Increase / (decrease) in income statement | | Increase / (decrease) in total equity at 31 December | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **PPOs**[1] | | | | |
| Impact of an increase in the discount rate used in the calculation of present values of 100 basis points ("**bps**") | **87.3** | 81.7 | **87.3** | 80.5 |
| Impact of a decrease in the discount rate used in the calculation of present values of 100bps | **(121.8)** | (118.5) | **(121.8)** | (116.8) |
| **Ogden**[2] | | | | |
| Impact of an increase in the Ogden discount rate by 100bps | **159.6** | 169.7 | **159.6** | 169.7 |
| Impact of a decrease in the Ogden discount rate by 100bps | **(224.0)** | (238.2) | **(224.0)** | (238.2) |

Notes:

1. The sensitivities relating to an increase or decrease in the discount rate used for PPOs illustrate a movement in the time value of money from the assumed level of 4.0%. An increase in the discount rate reflects a decrease in the time value of money and therefore the present value of future liabilities, which increases the total equity which would be reflected in the income statement.
2. The sensitivities relating to an increase or decrease in the Ogden discount rate illustrate a movement in the value from the current level of 2.5%. The Group holds provisions for a reduction in the Ogden discount rate at 31 December 2014 to 1.5%.
3. The selection of these sensitivities should not be interpreted as a prediction.
4. The sensitivities set out above reflect one-off impacts at 31 December.
5. The sensitivities set out above excluded the impact of taxation.

### Pricing and underwriting risks

The risk of economic loss arising from business being inappropriately accepted (i.e. outside underwriting rules / terms and conditions) and / or incorrectly priced.

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

### Claims management risk

The risk that claims are reserved or paid inappropriately, including the timing of such activity.

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

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

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

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

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

## 3. Risk management continued

### Reinsurance risk

The risk of inappropriate selection and / or placement of a reinsurance arrangement, with either individual or multiple reinsurers which renders the transfer of insurance risk to the reinsurer(s) inappropriate and / or ineffective. Other risks include:

- Reinsurance capacity being reduced and / or withdrawn;
- Underwriting risk appetite and reinsurance contract terms not being aligned;
- Reinsurance contract terms being inappropriate or ineffective resulting in classes or types of business not being appropriately reinsured;
- Non-adherence to the reinsurance policy terms and conditions, in terms of both policy management and claims not being handled within the reinsurance contract terms and conditions or paid on an ex-gratia basis resulting in reinsurance recoveries not being made in full;
- Inappropriate or inaccurate management information and / or modelling being used to determine the value for money and purchasing of reinsurance (including aggregate modelling); and
- Changes in the external legal, regulatory, social or economic environment altering the definition and application of reinsurance policy wordings or effectiveness / value for money of reinsurance.

The Group uses reinsurance to:

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

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

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

### Catastrophe risk

The risk of loss, or of adverse change, in the value of the insurance liabilities resulting from significant uncertainty of pricing and provisioning assumptions related to extreme or exceptional events.

### Insurance concentration risk

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

- geographic concentration risk – the Group purchases a UK catastrophe reinsurance programme to protect against a modelled 1 in 200-year loss. The retained deductible is £150 million at 31 December 2014 (2013: £150 million). There are also relevant covers to protect the Group's international businesses;
- product concentration risk – the Group's business is heavily concentrated in the UK general insurance market. However, the Group offers a diversified portfolio of products and a variety of brands sold through a range of distribution channels to its customers;
- sector concentration risk – the concentration of the Group to any given industry sector is monitored and analysed in respect of commercial customers; and
- reinsurance concentration risk – reinsurance is purchased from a number of providers to ensure that a diverse range of counterparties is contracted with, within the desired credit rating range.

It is important to note that none of these risk categories is independent of the others and that giving due considerations to the relationship between these risks is an important aspect of the effective management of insurance risk.

### 3.3.2 Financial risk

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

The strategic asset allocation within the investment portfolio is agreed by the Investment Committee. The Investment Committee determines policy and controls, covering such areas as risk, liquidity and performance. The Investment Committee meets at least three times a year to evaluate risk exposure, the current strategy, associated policies and investment guidelines and to consider investment recommendations submitted to it. Oversight of the implementation of decisions taken by the Investment Committee is via the 1st and 2nd Line of Defence.

The investment management objectives are:

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

#### 3.3.2.1 Market risk

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

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

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

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

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

The Group has a property portfolio and has commenced investment in infrastructure debt in order to improve matching to the longer duration PPOs.

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

##### Interest rate risk

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

The fixed interest rate up to 27 April 2022 on the Group's 30-year maturity £500 million of subordinated guaranteed dated notes has been exchanged for a floating rate of interest (note 29).

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

The market value of the Group's financial investments with fixed coupons are affected by the movement of interest rates. For the majority of investments in US Dollar corporate bonds (excluding £300 million of short duration high yield bonds), the Group hedges the exposure of this portfolio to the US Dollar interest rate risk using swaps. These derivatives reduce the duration of the portfolio to close to zero.

## 3. Risk management continued

### Spread risk

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

### Foreign currency risk

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

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

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

In September 2014, the Group entered into a forward foreign exchange contract to sell the Euro proceeds in exchange for Pounds Sterling, from the potential sale of the Italian and German entities. This mitigates foreign currency exposure in respect of the expected proceeds up to the sale settlement date.

### Property risk

Property risk results from adverse price fluctuations on commercial property investments. At 31 December 2014, the value of these property investments was £307.2 million (2013: £223.4 million). The property investments are located in the UK.

### Sensitivity analysis

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

| | Increase / (decrease) in income statement | | Increase / (decrease) in total equity at 31 December | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Spread** | | | | |
| Impact of a 100bps increase in spreads on financial investments and derivatives[1,2,4] | **–** | – | **(163.5)** | (187.8) |
| **Interest rate** | | | | |
| Impact of a 100bps increase in interest rates on financial investments and derivatives[1,3,4] | **19.1** | 18.0 | **(122.8)** | (170.5) |
| **Investment property** | | | | |
| Impact of a 15% decrease in property markets | **(46.1)** | (33.5) | **(46.1)** | (33.5) |

Notes:

1. The income statement impact on financial investments is limited to floating rate instruments and interest rate derivatives used to hedge a portion of the portfolio. The income statement is not impacted in relation to fixed rate instruments, in particular AFS debt securities, where the coupon return is not impacted by a change in prevailing market rates, as the accounting treatment for AFS debt securities means that only the coupon received is processed through the income statement with fair value movements being recognised through total equity.
2. The increase / (decrease) in total equity reflects a fair value movement in infrastructure debt that would not be recorded in the financial statements under IFRS as they are classified as loans and receivables which are carried at amortised cost. This result has been included in the table above to provide a comprehensive analysis of the fair value impact of this sensitivity.
3. The sensitivities set out above reflect one-off impacts at 31 December with the exception of the income statement interest rate sensitivity on financial investments and derivatives, which projects a movement in a full year's interest charge as a result of the increase in the interest rate applied to these assets / liabilities on those positions held at 31 December.
4. The subordinated liabilities and associated interest rate swap are excluded from the sensitivity analysis.
5. The selection of these sensitivities should not be interpreted as a prediction.
6. The sensitivities set out above have not considered the impact of the general market changes on the value of the Group's insurance liabilities or retirement benefit obligations.
7. The sensitivities set out above exclude the impact of taxation.
8. The sensitivities calculated above exclude the impact of assets held in the disposal group.

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

| At 31 December 2014 | Notional amounts £m | Maturity and fair value: Less than 1 year £m | 1 – 5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|
| **Derivative assets** | | | | | |
| **At fair value through the income statement:** | | | | | |
| Foreign exchange contracts (forwards) | 54.4 | 0.3 | – | – | 0.3 |
| Interest rate swaps | 696.6 | 0.9 | 1.2 | 22.5 | 24.6 |
| **Designated as hedging instruments:** | | | | | |
| Foreign exchange contracts (forwards) | 435.6 | 1.9 | 0.5 | – | 2.4 |
| **Total** | 1,186.6 | 3.1 | 1.7 | 22.5 | 27.3 |

| At 31 December 2014 | Notional amounts £m | Maturity and fair value: Less than 1 year £m | 1 – 5 years £m | Over 5 years £m | Total £m |
|---|---|---|---|---|---|
| **Derivative liabilities** | | | | | |
| **At fair value through the income statement:** | | | | | |
| Foreign exchange contracts (forwards) | 1,892.3 | 22.9 | – | – | 22.9 |
| Interest rate swaps | 424.9 | 1.3 | 0.5 | 4.6 | 6.4 |
| Interest rate futures[1] | 540.5 | – | – | – | – |
| **Designated as hedging instruments:** | | | | | |
| Foreign exchange contracts (forwards) | 5.0 | 0.1 | – | – | 0.1 |
| **Total** | 2,862.7 | 24.3 | 0.5 | 4.6 | 29.4 |

Note:

1. Interest rate futures are settled daily with variation margin and therefore have a fair value of £nil. The notional value is included in the above table to reflect the fact that the Group has exposure to open positions.

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

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

The Group has a number of open interest rate and foreign exchange derivative positions. Collateral management arrangements are in place for significant counterparty exposures. At 31 December 2014 the Group has pledged £17.3 million in cash (2013: £4.9 million in cash and £20.0 million UK Gilts) to cover out of the money derivative positions. At 31 December 2014 counterparties have pledged £21.5 million in UK Gilts (2013: £18.0 million in cash) to the Group to cover in the money derivative positions.

## 3. Risk management continued

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

### 3.3.2.2 Counterparty risk

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

Counterparty risk is primarily managed by the 1st line of defence and monitored by the Credit Risk Forum. The main responsibility of this forum is to ensure that all material aspects of counterparty risk within the Group are identified, monitored and measured.

The main sources of counterparty risk for the Group are:

- investment counterparty – this arises from the investment of monies in the range of investment vehicles permitted by the investment policy; and
- reinsurance recoveries – counterparty exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed. PPOs have the potential to increase the ultimate value of a claim and, by their very nature, to significantly increase the length of time to reach final payment. This has increased reinsurance counterparty risk in terms of both amount and longevity.

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

| At 31 December 2014 | Neither past due nor impaired £m | Past due 1 – 90 days £m | Past due more than 90 days £m | Assets that have been impaired £m | Carrying value in the balance sheet £m |
|---|---|---|---|---|---|
| Reinsurance assets | 862.5 | – | – | – | 862.5 |
| Insurance and other receivables | 907.3 | 52.0 | 0.6 | – | 959.9 |
| Derivative assets | 27.3 | – | – | – | 27.3 |
| AFS debt securities | 5,830.3 | – | – | – | 5,830.3 |
| Deposits with credit institutions with maturities > three months | 54.7 | – | – | – | 54.7 |
| Infrastructure debt | 76.2 | – | – | – | 76.2 |
| Short-term deposits with credit institutions | 729.1 | – | – | – | 729.1 |
| Cash at bank and in hand | 151.3 | – | – | – | 151.3 |
| Total[1] | 8,638.7 | 52.0 | 0.6 | – | 8,691.3 |

| At 31 December 2013 | Neither past due nor impaired £m | Past due 1 – 90 days £m | Past due more than 90 days £m | Assets that have been impaired £m | Carrying value in the balance sheet £m |
|---|---|---|---|---|---|
| Reinsurance assets | 1,011.0 | – | – | – | 1,011.0 |
| Insurance and other receivables | 1,075.8 | 42.8 | 3.4 | – | 1,122.0 |
| Derivative assets | 40.7 | – | – | – | 40.7 |
| AFS debt securities | 7,001.2 | – | – | 4.3 | 7,005.5 |
| Deposits with credit institutions with maturities > three months | 435.7 | – | – | – | 435.7 |
| Short-term deposits with credit institutions | 600.8 | – | – | – | 600.8 |
| Cash at bank and in hand | 307.5 | – | – | – | 307.5 |
| Total | 10,472.7 | 42.8 | 3.4 | 4.3 | 10,523.2 |

Note:

1. The carrying value of the financial and insurance assets for 2014 excludes the assets held for sale.

Within the analysis of AFS debt securities above are bank debt securities at 31 December 2014 of £1,328.3 million (2013: £1,625.2 million), that can be further analysed as: secured £104.1 million (2013: £135.9 million); unsecured £1,058.3 million (2013: £1,297.4 million); and subordinated £165.9 million (2013: £191.9 million).

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

| At 31 December 2014 | AAA £m | AA+ to AA- £m | A+ to A- £m | BBB+ to BBB- £m | BB+ and below £m | Total £m |
|---|---|---|---|---|---|---|
| Corporate | 235.2 | 556.6 | 2,096.5 | 935.2 | 293.6 | **4,117.1** |
| Supranational | 166.9 | 9.4 | – | – | – | **176.3** |
| Local government | 42.6 | 62.8 | 15.3 | – | – | **120.7** |
| Sovereign | – | 988.1 | – | 5.7 | – | **993.8** |
| Securitised credit[1] | 339.4 | 83.0 | – | – | – | **422.4** |
| **Total[2]** | **784.1** | **1,699.9** | **2,111.8** | **940.9** | **293.6** | **5,830.3** |

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

Notes:

1. Securitised credit is all in the form of prime mortgage backed securities, collateralised loan obligations, securitised student loans and commercial mortgage backed securities.
2. The credit quality of AFS debt securities in 2014 excludes assets held for sale.

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

| At 31 December 2014 | AAA £m | AA+ to AA– £m | A+ to A– £m | BBB+ to BBB- £m | BB+ and below £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| Reinsurance assets | – | 654.1 | 196.3 | 4.3 | – | 7.8 | **862.5** |
| Insurance and other receivables[1] | – | 17.3 | 17.4 | 15.5 | 0.4 | 856.7 | **907.3** |
| Derivative assets | – | 2.5 | 0.8 | 24.0 | – | – | **27.3** |
| Deposits with credit institutions with maturities > three months | – | 54.7 | – | – | – | – | **54.7** |
| Infrastructure debt | – | – | – | 76.2 | – | – | **76.2** |
| Short-term deposits with credit institutions | 729.1 | – | – | – | – | – | **729.1** |
| Cash at bank and in hand | – | – | 81.4 | 69.9 | – | – | **151.3** |
| **Total[2]** | **729.1** | **728.6** | **295.9** | **189.9** | **0.4** | **864.5** | **2,808.4** |

| At 31 December 2013 | AAA £m | AA+ to AA– £m | A+ to A– £m | BBB+ to BBB- £m | BB+ and below £m | Not rated £m | Total £m |
|---|---|---|---|---|---|---|---|
| Reinsurance assets | 0.3 | 710.9 | 289.0 | 0.7 | – | 10.1 | 1,011.0 |
| Insurance and other receivables[1] | – | 9.2 | 25.7 | 2.4 | – | 1,038.5 | 1,075.8 |
| Derivative assets | – | 5.7 | 35.0 | – | – | – | 40.7 |
| Deposits with credit institutions with maturities > three months | – | 55.0 | 380.7 | – | – | – | 435.7 |
| Short-term deposits with credit institutions | 545.8 | 5.0 | 50.0 | – | – | – | 600.8 |
| Cash at bank and in hand | – | 0.2 | 255.4 | 51.7 | – | 0.2 | 307.5 |
| **Total** | 546.1 | 786.0 | 1,035.8 | 54.8 | – | 1,048.8 | 3,471.5 |

Notes:

1. Other loans and receivables due from policyholders, agents, brokers and intermediaries generally do not have a credit rating.
2. The credit quality of financial and insurance assets in 2014 excludes assets held for sale.

## 3. Risk management continued

### Liquidity risk

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

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

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

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

| At 31 December 2014 | Total £m | Within 1 year £m | 1 – 3 years £m | 3 – 5 years £m | 5 – 10 years £m | Over 10 years £m |
|---|---|---|---|---|---|---|
| AFS debt securities | 5,830.3 | 938.3 | 1,663.4 | 1,175.3 | 1,669.8 | 383.5 |
| Deposits with credit institutions with maturities in excess of three months | 54.7 | 54.7 | – | – | – | – |
| Infrastructure debt | 76.2 | 2.8 | 9.4 | 7.5 | 23.3 | 33.2 |
| Short-term deposits with credit institutions | 729.1 | 729.1 | – | – | – | – |
| Cash at bank and in hand | 151.3 | 151.3 | – | – | – | – |
| **Total**[2] | **6,841.6** | **1,876.2** | **1,672.8** | **1,182.8** | **1,693.1** | **416.7** |

| At 31 December 2014 | Total £m | Within 1 year £m | 1 – 3 years £m | 3 – 5 years £m | 5 – 10 years £m | Over 10 years £m |
|---|---|---|---|---|---|---|
| Subordinated liabilities | 526.3 | 8.3 | – | – | 518.0 | – |
| Insurance liabilities[1] | 4,674.1 | 1,396.8 | 1,181.6 | 651.2 | 530.5 | 914.0 |
| Borrowings | 69.8 | 69.8 | – | – | – | – |
| Trade and other payables including insurance payables | 660.6 | 659.4 | 1.2 | – | – | – |
| **Total**[2] | **5,930.8** | **2,134.3** | **1,182.8** | **651.2** | **1,048.5** | **914.0** |

| At 31 December 2013 | Total £m | Within 1 year £m | 1 – 3 years £m | 3 – 5 years £m | 5 – 10 years £m | Over 10 years £m |
|---|---|---|---|---|---|---|
| AFS debt securities | 7,005.5 | 1,018.4 | 1,953.0 | 1,920.9 | 1,794.9 | 318.3 |
| Deposits with credit institutions with maturities in excess of three months | 435.7 | 435.7 | – | – | – | – |
| Short-term deposits with credit institutions | 600.8 | 600.8 | – | – | – | – |
| Cash at bank and in hand | 307.5 | 307.5 | – | – | – | – |
| **Total** | 8,349.5 | 2,362.4 | 1,953.0 | 1,920.9 | 1,794.9 | 318.3 |

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

Notes:

1. Insurance liabilities exclude unearned premium reserves as there are no liquidity risks inherent in them.
2. The assets and liabilities remaining duration tables for 2014 excludes assets and liabilities held for sale.

### Concentration risk

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

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

| At 31 December 2014 | Corporate £m | Local government £m | Sovereign £m | Securitised credit £m | AFS debt securities total £m | Infrastructure debt £m |
|---|---|---|---|---|---|---|
| Australia | 120.2 | – | – | – | 120.2 | – |
| Belgium | 33.8 | – | 3.6 | – | 37.4 | – |
| Canada | 60.8 | 34.3 | – | – | 95.1 | – |
| Cayman Islands | 19.3 | – | – | 218.8 | 238.1 | – |
| China | 6.1 | – | – | – | 6.1 | – |
| Denmark | 25.1 | – | – | – | 25.1 | – |
| Finland | – | 14.3 | – | – | 14.3 | – |
| France | 275.1 | 23.4 | – | – | 298.5 | – |
| Germany | 310.3 | 5.0 | – | – | 315.3 | – |
| Hong Kong | 8.5 | – | – | – | 8.5 | – |
| Italy | 15.5 | – | – | – | 15.5 | – |
| Japan | 46.9 | – | – | – | 46.9 | – |
| Luxembourg | 6.8 | – | – | – | 6.8 | – |
| Mexico | 12.6 | – | 5.7 | – | 18.3 | – |
| Netherlands | 154.4 | – | – | – | 154.4 | – |
| New Zealand | 3.6 | – | – | – | 3.6 | – |
| Norway | 24.4 | 10.1 | – | – | 34.5 | – |
| Singapore | 25.5 | – | – | – | 25.5 | – |
| South Korea | 7.5 | 7.6 | – | – | 15.1 | – |
| Spain | 30.6 | – | – | – | 30.6 | – |
| Sweden | 73.1 | 13.0 | – | – | 86.1 | – |
| Switzerland | 82.6 | – | – | – | 82.6 | – |
| UAE | – | 7.0 | – | – | 7.0 | – |
| UK | 1,334.8 | – | 984.5 | 69.4 | 2,388.7 | 76.2 |
| USA | 1,439.6 | 6.0 | – | 134.2 | 1,579.8 | – |
| Supranational | – | – | – | – | 176.3 | – |
| **Total**[1] | **4,117.1** | **120.7** | **993.8** | **422.4** | **5,830.3** | **76.2** |

Note:

1. The distribution of AFS debt securities and infrastructure debt by geographical area excludes assets held for sale.

## 3. Risk management continued

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

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

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

| | 2014 | | 2013 | |
|---|---|---|---|---|
| At 31 December | £m | % | £m | % |
| Basic materials | 151.9 | 3% | 196.5 | 3% |
| Communications | 298.5 | 5% | 394.1 | 6% |
| Consumer, cyclical | 230.7 | 4% | 192.9 | 3% |
| Consumer, non-cyclical | 363.4 | 6% | 451.0 | 6% |
| Diversified | 65.9 | 1% | 82.3 | 1% |
| Energy | 225.7 | 4% | 249.9 | 4% |
| Financial | 1,842.4 | 32% | 2,163.3 | 31% |
| Industrial | 250.7 | 4% | 274.9 | 4% |
| Mortgage and other asset backed securities | 422.4 | 7% | 227.7 | 3% |
| Sovereign, supranational and local government | 1,290.7 | 22% | 1,899.7 | 27% |
| Technology | 67.8 | 1% | 51.5 | 1% |
| Transport | 15.2 | 0% | 18.0 | 0% |
| Utilities | 605.0 | 11% | 803.7 | 11% |
| Total[1] | 5,830.3 | 100% | 7,005.5 | 100% |

Note:

1. The distribution of AFS debt securities by industry sector in 2014 excludes assets held for sale.

The table below analyses the distribution of infrastructure debt by industry sector classifications (2013: £nil).

| | 2014 | |
|---|---|---|
| At 31 December | £m | % |
| Social infrastructure | 56.6 | 74% |
| Transport | 19.6 | 26% |
| Total[1] | 76.2 | 100% |

Note:

1. The distribution of infrastructure debt by industry sector in 2014 excludes assets held for sale.

### 3.4 Capital adequacy

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

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

The UK regulated insurance entities of the Group carry out an assessment of the adequacy of their overall financial resources in accordance with the PRA's ICA methodology. The UK insurance capital requirement is calculated on an internal model which is calibrated to a 99.5% confidence interval and considers business written to date and one year of future business. Additionally, the model allows for the uncertainty around the run-off of this business. The risk-based capital model also supports decision making in the business. The Group also monitors its financial resources with reference to the requirements of the IGD.

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

The Group has an IGD surplus at 31 December 2014 of approximately £1.9 billion (2013: £1.8 billion). From 1 January 2016, the Group's regulatory capital position will be assessed against the Solvency II framework.

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

## 4. Segmental analysis

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

### Motor

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

### Home

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

### Rescue and other personal lines

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

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

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

### Commercial

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

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

### Run-off

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

### Discontinued operations – International

This segment consists primarily of personal motor car insurance cover sold in Italy and Germany using a multi-channel strategy through the Direct Line brand and through partnerships and PCWs. On 25 September 2014, the Group entered into a binding agreement for the sale, subject to regulatory approval, of this segment and accordingly its results have been treated as a discontinued operation. The segmental analysis of revenues and results on pages 131 to 132 has been re-presented to reflect this treatment with the revenue and results of the discontinued operations separately disclosed in note 5. The assets and liabilities of the International segment have been presented as a disposal group and have been classified as held for sale.

No inter-segment transactions occurred in the year ended 31 December 2014 (2013: £nil). If any transaction were to occur, transfer prices between operating segments would be set on an arm's length basis in a manner similar to transactions with third parties. Segment income, expenses and results will include those transfers between business segments which will then be eliminated on consolidation.

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

The table below is an analysis of the Group's revenue and results for continuing operations by reportable segment in the year ended 31 December 2014.

| | Motor[1] £m | Home £m | Rescue and other personal lines £m | Commercial £m | Total ongoing £m | Run-off £m | Continuing operations £m |
|---|---|---|---|---|---|---|---|
| Gross written premium | 1,342.0 | 898.6 | 371.8 | 487.0 | 3,099.4 | (0.4) | 3,099.0 |
| Gross earned premium | 1,372.6 | 920.4 | 370.5 | 481.1 | 3,144.6 | (0.4) | 3,144.2 |
| Reinsurance premium ceded | (76.7) | (45.1) | (1.4) | (34.3) | (157.5) | – | (157.5) |
| **Net earned premium** | 1,295.9 | 875.3 | 369.1 | 446.8 | 2,987.1 | (0.4) | 2,986.7 |
| Investment return | 144.8 | 25.7 | 6.1 | 34.0 | 210.6 | 4.5 | 215.1 |
| Instalment income | 69.6 | 24.0 | 1.5 | 5.3 | 100.4 | – | 100.4 |
| Other operating income | 32.9 | 0.7 | 10.8 | 2.5 | 46.9 | – | 46.9 |
| **Total income** | 1,543.2 | 925.7 | 387.5 | 488.6 | 3,345.0 | 4.1 | 3,349.1 |
| Insurance claims | (931.5) | (445.1) | (211.9) | (261.7) | (1,850.2) | 71.6 | (1,778.6) |
| Insurance claims recoverable from reinsurers | 63.4 | 0.8 | – | 6.4 | 70.6 | (19.4) | 51.2 |
| **Net insurance claims** | (868.1) | (444.3) | (211.9) | (255.3) | (1,779.6) | 52.2 | (1,727.4) |
| Commission expenses | (41.4) | (190.3) | (34.5) | (87.8) | (354.0) | – | (354.0) |
| Operating expenses | (336.6) | (177.2) | (93.1) | (98.5) | (705.4) | (1.0) | (706.4) |
| **Total expenses** | (378.0) | (367.5) | (127.6) | (186.3) | (1,059.4) | (1.0) | (1,060.4) |
| **Operating profit before restructuring and other one-off costs** | 297.1 | 113.9 | 48.0 | 47.0 | 506.0 | 55.3 | 561.3 |
| Restructuring and other one-off costs[2] | | | | | | | (69.6) |
| **Operating profit** | | | | | | | 491.7 |
| Finance costs | | | | | | | (37.2) |
| Gain on disposal of subsidiary | | | | | | | 2.3 |
| **Profit before tax** | | | | | | | 456.8 |
| **Underwriting profit** | 49.8 | 63.5 | 29.6 | 5.2 | 148.1 | | |
| Loss ratio | 67.0% | 50.8% | 57.4% | 57.1% | 59.6% | | |
| Commission ratio | 3.2% | 21.7% | 9.4% | 19.7% | 11.8% | | |
| Expense ratio | 26.0% | 20.2% | 25.2% | 22.0% | 23.6% | | |
| **Combined operating ratio** | 96.2% | 92.7% | 92.0% | 98.8% | 95.0% | | |

Notes:

1. The Group's revenue and results for the year ended 31 December 2014 relating to the Tracker business, which was disposed of on 5 February 2014, were recorded in the Motor segment (other operating income: £1.4 million and operating loss: £0.4 million).
2. Restructuring costs are costs which have been incurred in respect of the business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs that are non-recurring in nature.

## 4. Segmental analysis continued

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

| | Motor[1] £m | Home £m | Rescue and other personal lines[2] £m | Commercial £m | Total ongoing £m | Run-off[2] £m | Continuing operations[3] £m |
|---|---|---|---|---|---|---|---|
| Gross written premium | 1,421.1 | 943.1 | 383.4 | 474.5 | 3,222.1 | 7.9 | 3,230.0 |
| Gross earned premium | 1,498.4 | 958.9 | 383.1 | 468.7 | 3,309.1 | 7.9 | 3,317.0 |
| Reinsurance premium ceded | (53.6) | (50.0) | (17.3) | (34.1) | (155.0) | (5.2) | (160.2) |
| **Net earned premium** | 1,444.8 | 908.9 | 365.8 | 434.6 | 3,154.1 | 2.7 | 3,156.8 |
| Investment return | 122.8 | 24.1 | 8.2 | 29.6 | 184.7 | 13.0 | 197.7 |
| Instalment income | 78.3 | 25.2 | 1.3 | 6.2 | 111.0 | – | 111.0 |
| Other operating income | 48.5 | 0.7 | 9.1 | 3.3 | 61.6 | – | 61.6 |
| **Total income** | 1,694.4 | 958.9 | 384.4 | 473.7 | 3,511.4 | 15.7 | 3,527.1 |
| Insurance claims | (978.3) | (476.7) | (240.0) | (274.8) | (1,969.8) | 88.0 | (1,881.8) |
| Insurance claims recoverable from reinsurers | 38.1 | (13.7) | 20.2 | 4.2 | 48.8 | (37.9) | 10.9 |
| **Net insurance claims** | (940.2) | (490.4) | (219.8) | (270.6) | (1,921.0) | 50.1 | (1,870.9) |
| Commission expenses | (36.3) | (177.9) | (27.3) | (92.2) | (333.7) | (0.8) | (334.5) |
| Operating expenses | (370.2) | (184.4) | (90.8) | (101.4) | (746.8) | (1.4) | (748.2) |
| **Total expenses** | (406.5) | (362.3) | (118.1) | (193.6) | (1,080.5) | (2.2) | (1,082.7) |
| **Operating profit before restructuring and other one-off costs** | 347.7 | 106.2 | 46.5 | 9.5 | 509.9 | 63.6 | 573.5 |
| Restructuring and other one-off costs[4] | | | | | | | (140.5) |
| **Operating profit** | | | | | | | 433.0 |
| Finance costs | | | | | | | (37.7) |
| Gain on disposal of subsidiary | | | | | | | 12.0 |
| **Profit before tax** | | | | | | | 407.3 |
| **Underwriting profit / (loss)** | 98.1 | 56.2 | 27.9 | (29.6) | 152.6 | | |
| Loss ratio | 65.1% | 53.9% | 60.1% | 62.3% | 60.9% | | |
| Commission ratio | 2.5% | 19.6% | 7.5% | 21.2% | 10.6% | | |
| Expense ratio | 25.6% | 20.3% | 24.8% | 23.3% | 23.7% | | |
| **Combined operating ratio** | 93.2% | 93.8% | 92.4% | 106.8% | 95.2% | | |

Notes:

1. The Group's revenue and results for the year ended 2013 relating to the Tracker business, which was disposed of on 5 February 2014, were recorded in the Motor segment (other operating income: £18.4 million and operating loss: £1.4 million).
2. The Group's revenue and results for the year ended 2013 relating to the Life business, which was disposed of on 28 November 2013, were recorded in two segments: Rescue and other personal lines (net earned premium: £11.8 million, net insurance claims: £1.8 million and operating profit: £6.4 million) and Run-off (net earned premium: £2.8 million, net insurance claims: £0.7 million and operating profit: £1.2 million).
3. The segmental results set out above have been re-presented from those presented in the 2013 Annual Report as a consequence of the transfer of the International segment to discontinued operations (note 5).
4. Restructuring costs are costs which have been incurred in respect of the business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs that are non-recurring in nature.

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

| At 31 December 2014 | Motor £m | Home £m | Rescue and other personal lines £m | Commercial £m | Run-off £m | Disposal group £m | Total £m |
|---|---|---|---|---|---|---|---|
| Goodwill | 126.4 | 45.8 | 28.7 | 10.1 | – | – | **211.0** |
| Disposal group – assets held for sale[1] | – | – | – | – | – | 1,205.4 | **1,205.4** |
| Other segment assets | 6,392.5 | 746.2 | 170.6 | 1,453.3 | 1,046.6 | – | **9,809.2** |
| Disposal group – liabilities held for sale[1] | – | – | – | – | – | (964.4) | **(964.4)** |
| Other segmental liabilities | (4,796.8) | (559.9) | (128.0) | (1,090.5) | (875.5) | – | **(7,450.7)** |
| **Reportable segment net assets** | **1,722.1** | **232.1** | **71.3** | **372.9** | **171.1** | **241.0** | **2,810.5** |

Note:

1. Comprise the assets and liabilities of International.

| At 31 December 2013[1] | Motor £m | Home £m | Rescue and other personal lines £m | Commercial £m | Run-off £m | International £m | Total £m |
|---|---|---|---|---|---|---|---|
| Goodwill | 126.4 | 45.8 | 28.7 | 10.1 | – | – | 211.0 |
| Other segment assets | 6,558.5 | 847.6 | 164.9 | 1,448.6 | 1,266.4 | 1,290.8 | 11,576.8 |
| Segment liabilities | (4,988.0) | (644.6) | (125.4) | (1,101.7) | (1,077.4) | (1,060.7) | (8,997.8) |
| **Reportable segment net assets** | 1,696.9 | 248.8 | 68.2 | 357.0 | 189.0 | 230.1 | 2,790.0 |

Note:

1. The allocation of other segment assets and segment liabilities has been revised from the values disclosed in the Annual Report and Accounts for 2013.

All continuing operations are in the UK. The reportable segment net assets do not represent the Group's view of the capital requirements for its operating segments.

## 5. Discontinued operations and disposal group

Following a strategic review of the International segment, the Board concluded that, although the operations in Italy (represented by Direct Line Insurance S.p.A) and Germany (represented by Direct Line Versicherung AG) occupied strong positions, a disposal would be likely to generate the most value to shareholders.

On 25 September 2014, the Group entered into a binding agreement with Mapfre International S.A., a wholly-owned subsidiary of Mapfre, S.A., for the sale of International. Accordingly the Group has treated this segment as discontinued operations and a disposal group.

### A) Discontinued operations

The following table analyses performance relating to the discontinued operations.

| | 2014 £m | 2013 £m |
|---|---|---|
| Gross written premium | 567.6 | 604.5 |
| Gross earned premium | 555.8 | 579.3 |
| Reinsurance premium ceded | (226.0) | (212.8) |
| **Net earned premium** | 329.8 | 366.5 |
| Investment return | 22.1 | 23.4 |
| Instalment income | 4.8 | 6.8 |
| Other operating income | 1.0 | 0.8 |
| **Total income** | 357.7 | 397.5 |
| Insurance claims | (404.2) | (453.0) |
| Insurance claims recoverable from reinsurers | 159.5 | 169.6 |
| **Net insurance claims** | (244.7) | (283.4) |
| Commission expenses | (63.0) | (57.9) |
| Operating expenses | (29.0) | (39.6) |
| **Total expenses** | (92.0) | (97.5) |
| **Profit before tax from discontinued operations** | 21.0 | 16.6 |
| Tax charge | (7.7) | (14.6) |
| **Profit after tax from discontinued operations** | 13.3 | 2.0 |
| **Underwriting loss** | (6.9) | (14.4) |
| Loss ratio | 74.2% | 77.3% |
| Commission ratio | 19.1% | 15.8% |
| Expense ratio | 8.8% | 10.8% |
| **Combined operating ratio** | 102.1% | 103.9% |

## 5. Discontinued operations and disposal group continued

The following table analyses the other comprehensive loss relating to discontinued operations, included in the consolidated statement of comprehensive income.

| | 2014 £m | 2013 £m |
|---|---|---|
| **Items that may be reclassified subsequently to income statement:** | | |
| Exchange differences on the translation of foreign operations | (15.5) | 4.2 |
| Fair value gain / (loss) on available-for-sale investments | 26.1 | (3.8) |
| Less: realised net gains on available-for-sale investments included in income statement | (6.6) | (5.0) |
| Tax relating to items that may be reclassified | (6.9) | 2.4 |
| **Other comprehensive loss for the year net of tax** | (2.9) | (2.2) |

The following table analyses the cash flows relating to the discontinued operations included in the consolidated cash flow statement.

| | 2014 £m | 2013 £m |
|---|---|---|
| Net cash generated from operating activities | 12.6 | 23.7 |
| Net cash used by investing activities | (8.4) | (3.9) |
| Net cash generated from financing activities | – | 8.4 |
| Effect of foreign exchange rate changes | (6.1) | (0.3) |
| **Net (decrease) / increase in cash and cash equivalents** | (1.9) | 27.9 |

### B) Disposal group

The following table analyses the assets and liabilities of the disposal group at 31 December 2014 (2013: nil). For comparison purposes the relevant assets and liabilities of the entities comprising the disposal group have been included in the table.

| | 2014 £m | For comparison purposes only 2013 £m |
|---|---|---|
| **Assets** | | |
| Intangible assets | 5.6 | 4.6 |
| Property, plant and equipment | 5.9 | 4.7 |
| Reinsurance assets | 183.0 | 202.9 |
| Deferred tax assets | 9.2 | 16.9 |
| Current tax assets | 1.4 | 1.3 |
| Deferred acquisition costs | 111.1 | 98.2 |
| Insurance and other receivables | 91.1 | 92.4 |
| Prepayments and accrued income | 3.6 | 1.3 |
| Financial investments | 706.9 | 779.0 |
| Cash and cash equivalents | 87.6 | 89.5 |
| **Total assets** | 1,205.4 | 1,290.8 |
| **Liabilities** | | |
| Insurance liabilities | 553.4 | 609.4 |
| Unearned premium reserve | 326.2 | 339.3 |
| Trade and other payables including insurance payables | 82.0 | 109.7 |
| Deferred tax liabilities | 0.8 | 2.3 |
| Current tax liabilities | 2.0 | – |
| **Total liabilities** | 964.4 | 1,060.7 |

In addition to the above assets and liabilities of the disposal group held for sale, the Group has a property asset held for sale at 31 December 2014 of £3.0 million (2013: £1.0 million).

## 6. Net earned premium

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Gross earned premium: | | |
| Gross written premium | 3,099.0 | 3,230.0 |
| Movement in unearned premium reserve | 45.2 | 87.0 |
| | 3,144.2 | 3,317.0 |
| Reinsurance premium ceded: | | |
| Premium payable | (182.5) | (159.5) |
| Movement in reinsurance unearned premium reserve | 25.0 | (0.7) |
| | (157.5) | (160.2) |
| Total | 2,986.7 | 3,156.8 |

## 7. Investment return

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Investment income: | | |
| Interest income from AFS debt securities | 154.0 | 151.9 |
| Cash and cash equivalent interest income | 5.2 | 6.9 |
| Rental income from investment property | 16.2 | 11.4 |
| Interest income from infrastructure debt | 0.1 | – |
| | 175.5 | 170.2 |
| Net realised (losses) / gains: | | |
| AFS debt securities | 16.2 | 20.7 |
| Derivatives | (86.2) | 21.5 |
| Investment property (note 19) | 2.3 | – |
| | (67.7) | 42.2 |
| Net unrealised gains / (losses): | | |
| Impairments of AFS debt securities[1] | 1.3 | – |
| Derivatives | 79.6 | (22.2) |
| Investment property (note 19) | 26.4 | 7.5 |
| | 107.3 | (14.7) |
| Total | 215.1 | 197.7 |

Note:

1. The impairment reversal relates to an AFS debt security originally impaired in 2011.

The table below analyses the realised and unrealised gains / (losses) on derivative instruments included in investment return.

| | Realised | Unrealised | Realised | Unrealised |
|---|---|---|---|---|
| Continuing operations | 2014 £m | 2014 £m | 2013 £m | 2013 £m |
| Derivative (losses) / gains | | | | |
| Foreign exchange forward contracts | (59.3) | (46.4) | 21.2 | 12.0 |
| Associated foreign exchange risk | (7.4) | 115.9 | 2.0 | (33.3) |
| Net (losses) / gains on foreign exchange forward contracts | (66.7) | 69.5 | 23.2 | (21.3) |
| Interest rate derivatives | (20.4) | (22.1) | (0.8) | 19.6 |
| Associated interest rate risk | 0.9 | 32.2 | (0.9) | (20.5) |
| Net (losses) / gains on interest rate derivatives | (19.5) | 10.1 | (1.7) | (0.9) |
| Total | (86.2) | 79.6 | 21.5 | (22.2) |

## 8. Other operating income

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Vehicle replacement referral income | 15.8 | 15.7 |
| Revenue from vehicle recovery and repair services[1] | 18.0 | 31.8 |
| Fee income from insurance intermediary services | 2.1 | 1.7 |
| Other income | 11.0 | 12.4 |
| Total | 46.9 | 61.6 |

Note:

1. This includes £1.4 million (2013: £18.4 million) in relation to the Tracker business disposed of on 5 February 2014.

## 9. Net insurance claims

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| Continuing operations | Gross £m | Reinsurance £m | Net £m | Gross £m | Reinsurance £m | Net £m |
| Current accident year claims paid | 1,086.4 | – | 1,086.4 | 1,079.0 | (17.4) | 1,061.6 |
| Prior accident year claims paid | 1,165.8 | (21.8) | 1,144.0 | 1,383.3 | (22.6) | 1,360.7 |
| Movement in insurance liabilities | (473.6) | (29.4) | (503.0) | (580.5) | 29.1 | (551.4) |
| Total | 1,778.6 | (51.2) | 1,727.4 | 1,881.8 | (10.9) | 1,870.9 |

Claims handling expenses for the year ended 31 December 2014 of £226.3 million (2013: £239.5 million) have been included in the claims figures above.

## 10. Commission expenses

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Commission expenses | 263.3 | 275.4 |
| Expenses incurred under profit participations | 90.7 | 59.1 |
| Total | 354.0 | 334.5 |

## 11. Operating expenses

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Staff costs | 263.6 | 356.4 |
| Marketing | 123.9 | 159.2 |
| Depreciation | 22.6 | 18.5 |
| Amortisation and impairment of other intangible assets | 66.4 | 33.7 |
| Other operating expenses | 299.5 | 320.9 |
| Total | 776.0 | 888.7 |

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

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Staff costs[1] | 15.5 | 57.9 |
| Other operating expenses | 54.1 | 82.6 |
| Total | 69.6 | 140.5 |

Note:

1. Staff costs in 2013 include redundancy costs of £40.9 million.

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

| Continuing operations | 2014 | 2013 |
|---|---|---|
| Operations | 9,959 | 10,892 |
| Support | 1,278 | 1,773 |
| Total | 11,237 | 12,665 |

The Group's discontinued operations employed an average monthly number of 1,275 people in 2014 (2013: 1,295).

The aggregate remuneration of those employed by the Group's operations comprised:

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Wages and salaries | 348.7 | 395.0 |
| Social security costs | 37.7 | 43.7 |
| Pension costs | 19.2 | 24.3 |
| Share-based payments | 6.6 | 4.1 |
| Total | 412.2 | 467.1 |

The aggregate remuneration of those employed by the Group's discontinued operations was £32.9 million in 2014 (2013: £33.9 million).

The table below analyses Auditor's remuneration in respect of the Group's operations.

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Fees payable for the audit of: | | |
| The Company's annual accounts | 0.4 | 0.4 |
| The Company's subsidiaries | 1.5 | 1.4 |
| Total audit fees | 1.9 | 1.8 |
| Fees payable for non-audit services: | | |
| Audit-related assurance services | 0.1 | 0.1 |
| Taxation advisory services | 0.2 | – |
| Other services | 0.1 | – |
| Total non-audit services | 0.4 | 0.1 |
| Total | 2.3 | 1.9 |

The audit fees in respect of the Group's discontinued operations were £0.4 million in 2014 (2013: £0.3 million).

### Aggregate Directors' emoluments

The table below analyses the total amount of Directors' remuneration, all of which is in relation to continuing operations, in accordance with Schedule 5 to the Accounting Regulations.

| | 2014 £m | 2013 £m |
|---|---|---|
| Salaries, fees, bonuses and benefits in kind | 3.4 | 3.2 |
| Gains on exercise of share options | 1.2 | 0.5 |
| Defined contribution pension scheme contributions | 0.1 | 0.1 |
| Total | 4.7 | 3.8 |

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

At 31 December 2014, one Director (2013: one) had retirement benefits accruing under the defined contribution pension scheme in respect of qualifying service.

During the year ended 31 December 2014, two Directors exercised share options (2013: two Directors exercised share options) in relation to RBS Group LTIP awards and incentive deferral plans.

## 12. Finance costs

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Interest expense on subordinated liabilities[1] | 37.2 | 37.7 |

Note:

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

## 13. Tax charge

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Current taxation: | | |
| Charge for the year | 87.2 | 91.9 |
| Under provision in respect of prior year | 3.9 | 2.8 |
| | 91.1 | 94.7 |
| Deferred taxation (note 14): | | |
| Charge for the year | 14.0 | 4.7 |
| Over provision in respect of prior year | (7.6) | (2.9) |
| | 6.4 | 1.8 |
| Current taxation | 91.1 | 94.7 |
| Deferred taxation (note 14) | 6.4 | 1.8 |
| Tax charge for the year | 97.5 | 96.5 |

The following table analyses the difference between the actual income tax charge and the expected income tax charge computed by applying the standard rate of UK corporation tax of 21.5% (2013: 23.25%).

| | 2014 £m | 2013 £m |
|---|---|---|
| Profit before tax | 456.8 | 407.3 |
| Expected tax charge | 98.2 | 94.7 |
| Effects of: | | |
| Realised gains on disposal of subsidiaries | (0.5) | (2.8) |
| Disallowable expenses | 3.4 | 4.4 |
| Non-taxable items | – | 0.6 |
| Effect of change in UK taxation rate | 0.1 | (0.3) |
| Over provision in respect of prior year | (3.7) | (0.1) |
| Tax charge for the year | 97.5 | 96.5 |
| Effective income tax rate | 21.3% | 23.7% |

Note:

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

## 14. Current and deferred tax

### Current tax

| | 2014 £m | 2013 £m |
|---|---|---|
| **Per balance sheet:** | | |
| **Current tax assets**[1] | **0.1** | 1.3 |
| **Current tax liabilities**[1] | **(35.7)** | (21.1) |

Note:

1. Included in the disposal group (note 5B) are current tax assets of £1.4 million and current tax liabilities of £2.0 million which were transferred from current tax assets and current tax liabilities at 31 December 2014.

### Deferred tax

| | 2014 £m | 2013 £m |
|---|---|---|
| **Per balance sheet:** | | |
| **Deferred tax assets**[1] | **–** | 19.3 |
| **Deferred tax liabilities**[1] | **(20.6)** | (19.3) |
| | **(20.6)** | – |

Note:

1. Included in the disposal group (note 5B) are deferred tax assets of £9.2 million and deferred tax liabilities of £0.8 million which were transferred from deferred tax assets and deferred tax liabilities at 31 December 2014.

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

| | Provisions and other temporary differences £m | Retirement benefit obligations £m | Depreciation in excess of capital allowances £m | Non-distributable reserve £m | Investment properties £m | Share-based payments £m | Total £m |
|---|---|---|---|---|---|---|---|
| **At 1 January 2013** | 18.0 | (0.6) | 0.4 | (15.4) | – | (0.8) | 1.6 |
| Credit / (charge) to the income statement on continuing operations | 0.5 | (0.5) | 0.7 | (3.5) | (1.5) | 2.5 | (1.8) |
| Charge to the income statement on discontinued operations | (5.0) | – | – | – | – | – | (5.0) |
| Credit to other comprehensive income | 2.4 | 1.5 | – | – | – | – | 3.9 |
| Credit direct to equity | – | – | – | – | – | 0.2 | 0.2 |
| Other movements | 1.4 | – | (0.7) | 0.4 | – | – | 1.1 |
| **At 31 December 2013** | 17.3 | 0.4 | 0.4 | (18.5) | (1.5) | 1.9 | – |
| Credit / (charge) to the income statement on continuing operations | **2.6** | **(0.5)** | **0.5** | **(6.5)** | **(3.3)** | **0.8** | **(6.4)** |
| Credit to the income statement on discontinued operations | **2.1** | **–** | **–** | **–** | **–** | **–** | **2.1** |
| Charge to other comprehensive income | **(7.4)** | **(0.6)** | **–** | **–** | **–** | **–** | **(8.0)** |
| Credit direct to equity | **–** | **–** | **–** | **–** | **–** | **1.0** | **1.0** |
| Other movements | **(0.8)** | **–** | **(0.1)** | **–** | **–** | **–** | **(0.9)** |
| Transfer to liabilities / assets held for sale (note 5B) | **(8.4)** | **–** | **–** | **–** | **–** | **–** | **(8.4)** |
| **At 31 December 2014** | **5.4** | **(0.7)** | **0.8** | **(25.0)** | **(4.8)** | **3.7** | **(20.6)** |

## 15. Dividends

| | 2014 £m | 2013 £m |
|---|---|---|
| Amounts recognised as distributions to equity holders in the period: | | |
| 2013 final dividend of 8.4p per share paid on 15 May 2014 | 125.7 | – |
| 2012 final dividend of 8.0p per share paid on 11 June 2013 | – | 120.0 |
| 2014 first interim dividend of 4.4p per share paid on 12 September 2014 | 65.8 | – |
| 2013 interim dividend of 4.2p per share paid on 26 September 2013 | – | 62.8 |
| 2014 first special interim dividend of 10.0p per share paid on 12 September 2014 | 149.7 | – |
| 2013 first special interim dividend of 4.0p per share paid on 31 December 2013 | – | 59.9 |
| 2013 second special interim dividend of 4.0p per share paid on15 May 2014 | 59.9 | – |
| | 401.1 | 242.7 |
| Proposed dividends: | | |
| 2014 final dividend[1] of 8.8p per share | 132.0 | – |
| 2013 final dividend of 8.4p per share | – | 126.0 |
| 2014 second special interim dividend of 4.0p per share | 60.0 | – |
| 2013 second special interim dividend of 4.0p per share | – | 60.0 |

Note:

1. The Board has resolved this year to pay an interim dividend in lieu of a final dividend. The second special dividend is referred to separately from the final dividend. This enables more appropriate comparison to the 2013 final dividend.

The proposed final and second special interim dividends for 2014 have not been included as liabilities in these financial statements.

The trustees of the employee share trusts waived their entitlement to dividends on shares, which are not held for the benefit of employees (except for free share awards), which reduced the total dividend paid by £0.9 million (2013: £0.3 million).

## 16. Earnings and net assets per share, return on equity

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

### Basic

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Earnings attributable to owners of the Company arising from: | | |
| Continuing operations | 359.3 | 310.8 |
| Discontinued operations | 13.3 | 2.0 |
| Continuing and discontinued operations | 372.6 | 312.8 |
| Weighted average number of Ordinary Shares for the purpose of basic earnings per share (millions) | 1,495.0 | 1,495.4 |
| **Basic earnings per share (pence):** | | |
| **Continuing operations** | 24.0 | 20.8 |
| **Discontinued operations** | 0.9 | 0.1 |
| **Continuing and discontinued operations** | 24.9 | 20.9 |

### Diluted

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Earnings attributable to owners of the Company arising from: | | |
| Continuing operations | 359.3 | 310.8 |
| Discontinued operations | 13.3 | 2.0 |
| Continuing and discontinued operations | 372.6 | 312.8 |
| Weighted average number of Ordinary Shares for the purpose of diluted earnings per share (millions) | 1,495.0 | 1,495.4 |
| Effect of dilutive potential of share options and contingently issuable shares (millions) | 12.9 | 5.8 |
| Weighted average number of Ordinary Shares for diluted earnings per share (millions) | 1,507.9 | 1,501.2 |
| **Diluted earnings per share (pence):** | | |
| **Continuing operations** | 23.8 | 20.7 |
| **Discontinued operations** | 0.9 | 0.1 |
| **Continuing and discontinued operations** | 24.7 | 20.8 |

### Net asset value and tangible net asset value per share

Net asset value per share is calculated as total shareholders' equity divided by the number of Ordinary Shares at the end of the period excluding shares held by employee share trusts.

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

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

| At 31 December | 2014 £m | 2013 £m |
|---|---|---|
| Net assets | 2,810.5 | 2,790.0 |
| Goodwill and other intangible assets | (517.5) | (500.1) |
| Disposal group – intangible assets (note 5B) | (5.6) | – |
| Tangible net assets | 2,287.4 | 2,289.9 |
| Number of Ordinary Shares (millions) | 1,500.0 | 1,500.0 |
| Shares held by employee share trusts (millions) | (6.4) | (5.2) |
| Closing number of Ordinary Shares (millions) | 1,493.6 | 1,494.8 |
| **Net asset value per share (pence)** | 188.2 | 186.6 |
| **Tangible net asset value per share (pence)** | 153.1 | 153.2 |

### Return on equity

The table below details the calculation of return on equity.

| | 2014 £m | 2013 £m |
|---|---|---|
| Earnings attributable to owners of the Company | 372.6 | 312.8 |
| Opening shareholders' equity | 2,790.0 | 2,831.6 |
| Closing shareholders' equity | 2,810.5 | 2,790.0 |
| Average shareholders' equity | 2,800.2 | 2,810.8 |
| **Return on equity** | 13.3% | 11.1% |

## 17. Goodwill and other intangible assets

| | Goodwill £m | Other intangible assets £m | Total £m |
|---|---|---|---|
| **Cost** | | | |
| **At 1 January 2013** | 344.6 | 329.4 | 674.0 |
| Effect of foreign currency exchange adjustment | – | 0.8 | 0.8 |
| Additions | – | 115.5 | 115.5 |
| Disposal of subsidiary | (1.8) | – | (1.8) |
| **At 31 December 2013** | 342.8 | 445.7 | 788.5 |
| Effect of foreign currency exchange adjustment | – | (2.6) | (2.6) |
| Additions | – | 92.8 | 92.8 |
| Disposal of subsidiary[1] | (110.1) | (1.6) | (111.7) |
| Disposals and write-off[2] | – | (67.2) | (67.2) |
| Transfer to assets held for sale (note 5B) | (21.7) | (38.6) | (60.3) |
| **At 31 December 2014** | 211.0 | 428.5 | 639.5 |
| **Accumulated amortisation and impairment** | | | |
| **At 1 January 2013** | 133.6 | 118.9 | 252.5 |
| Charge for the year relating to continuing operations | – | 33.7 | 33.7 |
| Charge for the year relating to discontinued operations | – | 3.5 | 3.5 |
| Effect of foreign currency exchange adjustment | – | 0.5 | 0.5 |
| Disposal of subsidiary | (1.8) | – | (1.8) |
| **At 31 December 2013** | 131.8 | 156.6 | 288.4 |
| Charge for the year relating to continuing operations | – | 56.9 | 56.9 |
| Charge for the year relating to discontinued operations | – | 2.2 | 2.2 |
| Effect of foreign currency exchange adjustment | – | (2.2) | (2.2) |
| Disposal of subsidiary[1] | (110.1) | (0.9) | (111.0) |
| Disposals and write-off[2] | – | (67.2) | (67.2) |
| Impairment losses | – | 9.6 | 9.6 |
| Transfer to assets held for sale (note 5B) | (21.7) | (33.0) | (54.7) |
| **At 31 December 2014** | – | 122.0 | 122.0 |
| **Carrying amount** | | | |
| **At 31 December 2014** | 211.0 | 306.5 | 517.5 |
| **At 31 December 2013** | 211.0 | 289.1 | 500.1 |

Notes:

1. Disposal of subsidiary relates to the Tracker business.
2. Disposals and write-off include fully amortised intangible assets no longer utilised by the Group in its operating activities.

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

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

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Motor | 126.4 | 126.4 |
| Home | 45.8 | 45.8 |
| Rescue and other personal lines | 28.7 | 28.7 |
| Commercial | 10.1 | 10.1 |
| **Total** | 211.0 | 211.0 |

There have been no impairments in goodwill in the year ended 31 December 2014 (2013: nil).

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

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

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

| | Assumptions | | | Sensitivity: Impact on recoverable amount of a: | | |
|---|---|---|---|---|---|---|
| CGU | Terminal growth rate % | Pre-tax discount rate % | Recoverable amount in excess of carrying value £m | 1% decrease in terminal growth rate £m | 1% increase in pre-tax discount rate £m | 1% decrease in forecast pre-tax profit[1] £m |
| Motor | 3.0 | 11.8% | 914.2 | (189.0) | (262.2) | (25.8) |
| Home | 3.0 | 11.8% | 644.4 | (67.8) | (93.2) | (8.8) |
| Rescue and other personal lines | 3.0 | 11.8% | 622.1 | (55.7) | (76.3) | (7.0) |
| Commercial | 3.0 | 11.8% | 133.4 | (37.4) | (51.7) | (4.9) |

Note:

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

## 18. Property, plant and equipment

| | Freehold land and buildings £m | Other equipment £m | Total £m |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2013 | 4.4 | 138.0 | 142.4 |
| Additions | 10.9 | 28.2 | 39.1 |
| Disposals | – | (6.3) | (6.3) |
| Disposal of subsidiary | – | (0.2) | (0.2) |
| Effect of foreign currency exchange adjustment | – | 0.3 | 0.3 |
| At 31 December 2013 | 15.3 | 160.0 | 175.3 |
| Additions | 43.4 | 43.3 | 86.7 |
| Disposals | – | (16.6) | (16.6) |
| Acquisition of subsidiary | 25.1 | – | 25.1 |
| Disposal of subsidiary | – | (3.5) | (3.5) |
| Effect of foreign currency exchange adjustment | – | (1.7) | (1.7) |
| Transfer to assets held for sale (note 5B) | – | (27.2) | (27.2) |
| At 31 December 2014 | 83.8 | 154.3 | 238.1 |
| **Accumulated depreciation and impairment** | | | |
| At 1 January 2013 | 0.9 | 49.1 | 50.0 |
| Depreciation charge for the year relating to continuing operations | 0.2 | 18.3 | 18.5 |
| Depreciation charge for the year relating to discontinued operations | – | 2.5 | 2.5 |
| Disposals | – | (3.4) | (3.4) |
| Impairment losses | – | 5.5 | 5.5 |
| Disposal of subsidiary | – | (0.2) | (0.2) |
| Effect of foreign currency exchange adjustment | – | 0.1 | 0.1 |
| At 31 December 2013 | 1.1 | 71.9 | 73.0 |
| Depreciation charge for the year relating to continuing operations | 0.6 | 22.0 | 22.6 |
| Depreciation charge for the year relating to discontinued operations | – | 3.0 | 3.0 |
| Disposals | – | (16.3) | (16.3) |
| Impairment losses | – | 0.1 | 0.1 |
| Disposal of subsidiary | – | (2.9) | (2.9) |
| Effect of foreign currency exchange adjustment | – | (1.4) | (1.4) |
| Transfer to assets held for sale (note 5B) | – | (21.3) | (21.3) |
| At 31 December 2014 | 1.7 | 55.1 | 56.8 |
| **Carrying amount** | | | |
| At 31 December 2014 | 82.1 | 99.2 | 181.3 |
| At 31 December 2013 | 14.2 | 88.1 | 102.3 |

## 19. Investment property

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | 223.4 | 128.9 |
| Additions | 76.2 | 87.0 |
| Increase in fair value during the year | 28.7 | 7.5 |
| Disposals | (21.1) | – |
| At 31 December | 307.2 | 223.4 |

Note:

1. The cost included in carrying value at 31 December 2014 is £279.5 million (2013: £220.7 million).

The investment properties are measured at fair value which was arrived at on the basis of a valuation carried out at the balance sheet date by independent valuers.

The valuation conforms to international valuation standards. The fair value was determined using a methodology based on recent market transactions for similar properties, which have been adjusted for the specific characteristics of each property within the portfolio. This approach to valuation is consistent with the methodology used in the year ended 31 December 2013.

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

## 20. Subsidiaries

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

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

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

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

On 25 September 2014, the Group entered into a binding agreement for the sale, subject to regulatory approval, of its International business comprising Direct Line Insurance S.p.A and Direct Line Versicherung AG for a cash consideration of €550.0 million (£430.1 million).

The Group sold 100% of the share capital of Tracker Network (UK) Limited on 5 February 2014. The fair value of the identifiable assets sold was £9.2 million (including cash and cash equivalents of £2.4 million) and the fair value of the identifiable liabilities was £8.8 million. The total cash consideration received was £2.7 million, generating a profit on disposal of £2.3 million. Tracker generated other income of £1.4 million up to the point of sale (full year 2013: £18.4 million) and an operating loss of £0.4 million (2013: £1.4 million).

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

The Group did not dispose of any other subsidiaries in the two years ended 31 December 2014.

The Group acquired 100% of the share capital of 10-15 Livery Street, Birmingham UK Limited on 22 December 2014 for £26.1 million. The fair value of the identification assets acquired was £26.2 million (including cash and cash equivalents of £1.1 million and the fair value of identifiable liabilities was £0.1 million). The total cash consideration paid was £26.1 million. 10-15 Livery Street, Birmingham UK Limited owns a property occupied by the Group and has no other trading activities.

## 21. Reinsurance assets

| | 2014 £m | 2013 £m |
|---|---|---|
| Reinsurers' share of general insurance liabilities (including unearned premium reserve) | 928.9 | 1,064.2 |
| Impairment provision | (66.4) | (53.2) |
| **Total**[1] | 862.5 | 1,011.0 |

Note:

1. Included in the disposal group (note 5B) is £183.0 million which has been transferred from reinsurance assets at 31 December 2014.

### Movements in reinsurance asset impairment provision

| | 2014 £m | 2013 £m |
|---|---|---|
| **At 1 January** | (53.2) | (60.7) |
| Additional provision | (14.1) | (3.5) |
| Utilisation of provision | – | 2.0 |
| Release to income statement | 0.9 | 9.0 |
| **At 31 December** | (66.4) | (53.2) |

## 22. Deferred acquisition costs

| | 2014 £m | 2013 £m |
|---|---|---|
| **At 1 January** | 321.5 | 327.6 |
| Net increase / (decrease) in the year | 5.4 | (7.3) |
| Effect of foreign currency exchange adjustment | (7.4) | 1.2 |
| Transfer to assets held for sale (note 5B) | (111.1) | – |
| **At 31 December** | 208.4 | 321.5 |

## 23. Insurance and other receivables

| | 2014 £m | 2013 £m |
|---|---|---|
| Receivables arising from insurance and reinsurance contracts: | | |
| Due from policyholders | 790.7 | 927.9 |
| Impairment of policyholder receivables | (0.6) | (7.6) |
| Due from agents, brokers and intermediaries | 53.7 | 53.4 |
| Impairment of agent, broker and intermediary receivables | (0.7) | (0.5) |
| Due from reinsurers | 31.4 | 19.3 |
| Other loans and receivables: | | |
| Accrued interest | – | 1.2 |
| Receivables from related parties | – | 0.9 |
| Other debtors[1] | 85.4 | 127.4 |
| **Total**[2] | 959.9 | 1,122.0 |

Notes:

1. 2013 included £42.1 million in respect of a deposit for the purchase of owner-occupied property.
2. Included in the disposal group (note 5B) is £91.1 million which has been transferred from insurance and other receivables at 31 December 2014.

## 24. Derivative financial instruments

| | 2014 £m | 2013 £m |
|---|---|---|
| **Derivative assets** | | |
| At fair value through the income statement | 24.9 | 40.7 |
| Designated as hedging instruments | 2.4 | – |
| **Total** | 27.3 | 40.7 |
| **Derivative liabilities** | | |
| At fair value through the income statement | 29.3 | 17.8 |
| Designated as hedging instruments | 0.1 | 1.5 |
| **Total** | 29.4 | 19.3 |

The Group entered into a foreign currency hedge contract in September 2014, converting Euro to Pounds Sterling in respect of the expected proceeds in relation to the binding agreement for the sale of the International business. Other designated hedging instruments have been entered into relating to supplier payments.

## 25. Financial investments

| | 2014 £m | 2013 £m |
|---|---|---|
| **AFS debt securities** | | |
| Corporate | 4,117.1 | 4,878.1 |
| Supranational | 176.3 | 365.7 |
| Local government | 120.7 | 134.5 |
| Sovereign | 993.8 | 1,399.5 |
| Securitised credit | 422.4 | 227.7 |
| **Total** | 5,830.3 | 7,005.5 |
| **AFS debt securities** | | |
| Fixed interest rate | 5,147.3 | 6,468.4 |
| Floating interest rate | 683.0 | 537.1 |
| **Total** | 5,830.3 | 7,005.5 |
| **Loans and receivables** | | |
| Deposits with credit institutions with maturities in excess of three months | 54.7 | 435.7 |
| Infrastructure debt | 76.2 | – |
| **Total**[1] | 5,961.2 | 7,441.2 |

Note:

1. Included in the disposal group (note 5B) is £706.9 million which has been transferred from financial investments at 31 December 2014.

## 26. Cash and cash equivalents and borrowings

| | 2014 £m | 2013 £m |
|---|---|---|
| Cash at bank and in hand | 151.3 | 307.5 |
| Short-term deposits with credit institutions | 729.1 | 600.8 |
| **Total** | 880.4 | 908.3 |

The effective interest rate on short-term deposits with credit institutions for the year ended 31 December 2014 was 0.61% (2013: 0.41%) and average maturity was 10 days (2013: 14 days).

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Cash and cash equivalents | 880.4 | 908.3 |
| Bank overdrafts[1] | (69.8) | (55.1) |
| Cash and cash equivalents in assets held for sale (note 5B) | 87.6 | – |
| **Total** | 898.2 | 853.2 |

Note:

1. Bank overdrafts represent short-term timing differences between transactions posted in the records of the Group and transactions flowing through the accounts at the bank.

## 27. Share capital

| | 2014 £m | 2013 £m |
|---|---|---|
| Issued and fully paid: equity shares | | |
| 1.5 billion Ordinary Shares of 10 pence each | 150.0 | 150.0 |

### Employee trust shares

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

At 31 December 2014, 6,391,506 Ordinary Shares (2013: 5,204,771) were owned by the employee share trusts with a cost of £13.6 million (2013: £10.2 million) with an undertaking to satisfy the awards of shares in the Company under the Group's share plans.

These shares were purchased by the employee share trusts and are carried at cost. At 31 December 2014, they had an aggregate nominal value of £0.6 million (2013: £0.5 million) and a market value of £18.6 million (2013: £13.0 million).

## 28. Other reserves

### Movements in the revaluation reserve for AFS investments

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | 58.8 | 158.8 |
| Revaluation during the year – gross | 97.2 | (108.2) |
| Revaluation during the year – tax | (23.2) | 27.7 |
| Realised gains – gross | (22.8) | (23.9) |
| Realised gains – tax | 5.6 | 5.8 |
| Realised gain on disposal of subsidiary – gross | – | (1.8) |
| Realised gain on disposal of subsidiary – tax | – | 0.4 |
| At 31 December 2014 | 115.6 | 58.8 |

### Movements in the non-distributable reserve

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | 92.8 | 63.2 |
| Transfer from retained earnings | 32.1 | 29.6 |
| At 31 December | 124.9 | 92.8 |

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

## 29. Subordinated liabilities

| | 2014 £m | 2013 £m |
|---|---|---|
| Subordinated guaranteed dated notes | 526.3 | 486.6 |

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

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

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

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

The Group has the option to defer interest payments in certain circumstances on the notes but to date has not exercised this right.

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

| | 2014 £m | 2013 £m |
|---|---|---|
| **Insurance liabilities** | **4,674.1** | 5,757.4 |
| **Gross insurance liabilities (including unearned premium reserve)** | | |
| Gross insurance liabilities | **4,674.1** | 5,757.4 |
| Unearned premium reserve | **1,434.2** | 1,818.7 |
| **Total** | **6,108.3** | 7,576.1 |
| **Reinsurers' share of insurance liabilities (including reinsurance unearned premium reserve)** | | |
| Reinsurers' share of insurance liabilities | **(775.5)** | (917.3) |
| Unearned premium reserve | **(87.0)** | (93.7) |
| **Total** | **(862.5)** | (1,011.0) |
| **Net insurance liabilities (including unearned premium reserve)** | | |
| Net insurance liabilities | **3,898.6** | 4,840.1 |
| Unearned premium reserve | **1,347.2** | 1,725.0 |
| **Total** | **5,245.8** | 6,565.1 |

### Gross insurance liabilities

| Accident year | 2005 £m | 2006 £m | 2007 £m | 2008 £m | 2009 £m | 2010 £m | 2011 £m | 2012 £m | 2013 £m | 2014 £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | | | | | | |
| At end of accident year | 4,007.5 | 4,091.6 | 4,390.5 | 3,878.1 | 4,148.0 | 4,261.9 | 3,080.5 | 2,797.3 | 2,652.5 | 2,498.0 | |
| One year later | (175.8) | (266.1) | (62.0) | 23.2 | 120.0 | (98.1) | (80.3) | (168.7) | (128.5) | – | |
| Two years later | (141.7) | (42.0) | (1.1) | 43.9 | (42.5) | (115.3) | (99.5) | (121.3) | – | – | |
| Three years later | (57.9) | (17.6) | 49.4 | (38.3) | (24.2) | (55.1) | (93.4) | – | – | – | |
| Four years later | (59.5) | 10.1 | (7.0) | (22.0) | (101.8) | (105.3) | – | – | – | – | |
| Five years later | 15.3 | (21.6) | (17.8) | (57.9) | (40.7) | – | – | – | – | – | |
| Six years later | 7.8 | (9.1) | (26.3) | (45.3) | – | – | – | – | – | – | |
| Seven years later | 5.4 | (13.4) | (20.1) | – | – | – | – | – | – | – | |
| Eight years later | (34.4) | 2.3 | – | – | – | – | – | – | – | – | |
| Nine years later | 0.3 | – | – | – | – | – | – | – | – | – | |
| Current estimate of cumulative claims | 3,567.0 | 3,734.2 | 4,305.6 | 3,781.7 | 4,058.8 | 3,888.1 | 2,807.3 | 2,507.3 | 2,524.0 | 2,498.0 | |
| Cumulative payments to date | (3,456.4) | (3,533.9) | (4,056.5) | (3,570.9) | (3,679.4) | (3,462.0) | (2,340.6) | (2,029.9) | (1,734.0) | (1,150.0) | |
| Transfer to liabilities held for sale | (4.9) | (18.6) | (11.4) | (20.0) | (16.5) | (22.9) | (45.1) | (61.5) | (97.2) | (208.6) | |
| Liability recognised in balance sheet | **105.7** | **181.7** | **237.7** | **190.8** | **362.9** | **403.2** | **421.6** | **415.9** | **692.8** | **1,139.4** | **4,151.7** |
| 2004 and prior[1] | | | | | | | | | | | **417.6** |
| Claims handling provision[1] | | | | | | | | | | | **104.8** |
| **Total** | | | | | | | | | | | **4,674.1** |

Note:

1. Included in the disposal group (note 5B) in 2014 liabilities held for sale is £46.7 million (£28.5 million relating to 2004 and prior and £18.2 million relating to claims handling provision) which has been transferred from insurance liabilities.

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

### Net insurance liabilities

| Accident year | 2005 £m | 2006 £m | 2007 £m | 2008 £m | 2009 £m | 2010 £m | 2011 £m | 2012 £m | 2013 £m | 2014 £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | | | | | | |
| At end of accident year | 3,869.6 | 4,030.8 | 4,341.3 | 3,816.0 | 4,113.0 | 4,219.3 | 2,946.1 | 2,570.1 | 2,401.5 | 2,209.7 | |
| One year later | (159.3) | (249.7) | (81.7) | 24.1 | 70.0 | (109.7) | (119.3) | (157.8) | (128.3) | – | |
| Two years later | (159.4) | (52.7) | (23.3) | 8.2 | (23.0) | (136.4) | (88.1) | (109.5) | – | – | |
| Three years later | (62.0) | (28.2) | 17.7 | (24.5) | (64.2) | (48.5) | (78.3) | – | – | – | |
| Four years later | (61.6) | 9.9 | (10.4) | (51.2) | (67.5) | (92.8) | – | – | – | – | |
| Five years later | 7.2 | (43.5) | (22.4) | (51.2) | (30.8) | – | – | – | – | – | |
| Six years later | (0.4) | (21.0) | (21.2) | (31.1) | – | – | – | – | – | – | |
| Seven years later | (12.2) | (14.2) | (16.7) | – | – | – | – | – | – | – | |
| Eight years later | (27.1) | 3.8 | – | – | – | – | – | – | – | – | |
| Nine years later | 2.4 | – | – | – | – | – | – | – | – | – | |
| Current estimate of cumulative claims | 3,397.2 | 3,635.2 | 4,183.3 | 3,690.3 | 3,997.5 | 3,831.9 | 2,660.4 | 2,302.8 | 2,273.2 | 2,209.7 | |
| Cumulative payments to date | (3,325.9) | (3,485.1) | (3,990.3) | (3,531.1) | (3,646.1) | (3,444.0) | (2,244.3) | (1,905.4) | (1,611.4) | (1,053.4) | |
| Transfer to liabilities / assets held for sale | (4.9) | (12.6) | (11.5) | (17.7) | (16.5) | (22.7) | (31.9) | (41.3) | (61.5) | (140.4) | |
| Liability recognised in balance sheet | **66.4** | **137.5** | **181.5** | **141.5** | **334.9** | **365.2** | **384.2** | **356.1** | **600.3** | **1,015.9** | **3,583.5** |
| 2004 and prior[1] | | | | | | | | | | | 210.3 |
| Claims handling provision[1] | | | | | | | | | | | 104.8 |
| **Total** | | | | | | | | | | | **3,898.6** |

Note:

1. Included in the disposal group (note 5B) in 2014 liabilities held for sale is £46.7 million (£28.5 million relating to 2004 and prior and £18.2 million relating to claims handling provision) and assets held for sale of £14.1 million (relating to 2004 and prior reinsurance) which have been transferred from insurance liabilities and reinsurance assets respectively.

## Movements in insurance liabilities and reinsurance assets

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| Claims reported | 3,969.3 | (397.8) | 3,571.5 |
| Incurred but not reported | 2,153.9 | (511.6) | 1,642.3 |
| Claims handling provision | 163.8 | – | 163.8 |
| Liability adequacy provision | 4.3 | – | 4.3 |
| **At 1 January 2013** | 6,291.3 | (909.4) | 5,381.9 |
| Cash paid for claims settled in the year | (2,852.1) | 149.1 | (2,703.0) |
| Increase / (decrease) in liabilities: | | | |
| Arising from current-year claims | 2,894.2 | (250.9) | 2,643.3 |
| Arising from prior-year claims | (583.9) | 96.7 | (487.2) |
| Effect of foreign currency exchange adjustment | 12.2 | (2.8) | 9.4 |
| Decrease in liability adequacy provision | (4.3) | – | (4.3) |
| **At 31 December 2013** | 5,757.4 | (917.3) | 4,840.1 |
| Claims reported | 3,636.4 | (467.5) | 3,168.9 |
| Incurred but not reported | 1,992.7 | (449.8) | 1,542.9 |
| Claims handling provision | 128.3 | – | 128.3 |
| **At 31 December 2013** | 5,757.4 | (917.3) | 4,840.1 |
| Cash paid for claims settled in the year | **(2,671.6)** | **181.2** | **(2,490.4)** |
| Increase / (decrease) in liabilities: | | | |
| Arising from current-year claims | **2,721.3** | **(288.3)** | **2,433.0** |
| Arising from prior-year claims | **(538.5)** | **77.6** | **(460.9)** |
| Effect of foreign currency exchange adjustment | **(41.1)** | **11.5** | **(29.6)** |
| Transfer to (liabilities) / assets held for sale (note 5B) | **(553.4)** | **159.8** | **(393.6)** |
| **At 31 December 2014** | **4,674.1** | **(775.5)** | **3,898.6** |
| Claims reported | **2,791.1** | **(315.3)** | **2,475.8** |
| Incurred but not reported | **1,778.2** | **(460.2)** | **1,318.0** |
| Claims handling provision | **104.8** | **–** | **104.8** |
| **At 31 December 2014** | **4,674.1** | **(775.5)** | **3,898.6** |

## Movement in prior-year net claims liabilities by operating segment

| | 2014 £m | 2013 £m |
|---|---|---|
| Motor | **(278.4)** | (291.9) |
| Home | **(49.8)** | (43.3) |
| Rescue and other personal lines | **(15.7)** | (9.0) |
| Commercial | **(53.7)** | (51.6) |
| **Total ongoing** | **(397.6)** | (395.8) |
| Run-off | **(53.2)** | (52.1) |
| Discontinued – International | **(10.1)** | (39.3) |
| **Total** | **(460.9)** | (487.2) |

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

### Movement in unearned premium reserve

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| **At 1 January 2013** | 1,872.9 | (97.9) | 1,775.0 |
| Net movement in the year | (61.8) | 5.0 | (56.8) |
| Effect of foreign currency exchange adjustment | 7.6 | (0.8) | 6.8 |
| **At 31 December 2013** | 1,818.7 | (93.7) | 1,725.0 |
| Net movement in the year | **(33.4)** | **(18.6)** | **(52.0)** |
| Effect of foreign currency exchange adjustment | **(24.9)** | **2.1** | **(22.8)** |
| Transfer to (liabilities) / assets held for sale (note 5B) | **(326.2)** | **23.2** | **(303.0)** |
| **At 31 December 2014** | **1,434.2** | **(87.0)** | **1,347.2** |

## 31. Life insurance liabilities and reinsurance assets

### Movements in life insurance liabilities and reinsurance assets

| | Gross £m | Reinsurance £m | Net £m |
|---|---|---|---|
| **At 1 January 2013** | 102.9 | (91.1) | 11.8 |
| Provisions in respect of new and existing business | 34.5 | (21.4) | 13.1 |
| Expected change in existing business provisions | (19.8) | 17.3 | (2.5) |
| Variance between actual and expected experience | (3.0) | (5.0) | (8.0) |
| Other movements | (3.7) | – | (3.7) |
| Disposal[1] | (110.9) | 100.2 | (10.7) |
| **At 31 December 2013 and 31 December 2014** | **–** | **–** | **–** |

Note:

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

## 32. Retirement benefit obligations

### Defined contribution scheme

The pension charge for continuing operations in respect of the defined contribution scheme for the year ended 31 December 2014 was £19.2 million (2013: £23.9 million). The charge for discontinued operations was £1.8 million (2013: £1.4 million).

### Defined benefit scheme

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

The weighted average duration of the defined benefit obligations at 31 December 2014 is 20 years (2013: 20 years) using accounting assumptions.

The table below sets out the principal assumptions used in determining the defined benefit scheme obligations.

| | 2014 % | 2013 % |
|---|---|---|
| Rate of increase in pension payment | **2.1** | 2.1 |
| Rate of increase of deferred pensions | **2.1** | 2.6 |
| Discount rate | **3.4** | 4.4 |
| Inflation rate | **3.1** | 3.5 |

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

### Post-retirement mortality assumptions

| | 2014 | 2013 |
|---|---|---|
| Life expectancy at age 60 now: | | |
| Males | 88.5 | 88.4 |
| Females | 90.2 | 90.1 |
| Life expectancy at age 60 in 20 years' time: | | |
| Males | 90.4 | 90.3 |
| Females | 92.3 | 92.2 |

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

| | 2014 £m | 2013 £m |
|---|---|---|
| Equities | 3.0 | 3.5 |
| Index-linked bonds | 22.2 | 13.1 |
| Government bonds | 12.8 | 5.7 |
| Corporate bonds | 44.4 | 42.9 |
| Other | 0.7 | 0.8 |
| Total | 83.1 | 66.0 |

The majority of debt and equity instruments have quoted prices on active markets.

### Movement in net pension surplus / (deficit)

| | Fair value of defined benefit scheme assets £m | Present value of defined benefit scheme obligations £m | Net pension surplus / (deficit) £m |
|---|---|---|---|
| At 1 January 2013 | 63.7 | (61.2) | 2.5 |
| Income statement: | | | |
| Net interest income / (cost)[1] | 2.3 | (2.7) | (0.4) |
| Statement of comprehensive income: | | | |
| Actuarial losses arising from experience adjustments | (1.3) | (0.2) | (1.5) |
| Actuarial losses arising from changes in financial assumptions | – | (4.4) | (4.4) |
| Actuarial losses arising from changes in demographic assumptions | – | (1.0) | (1.0) |
| Contributions by employer | 2.8 | – | 2.8 |
| Benefits paid | (1.5) | 1.5 | – |
| At 31 December 2013 | 66.0 | (68.0) | (2.0) |
| Income statement: | | | |
| Net interest income / (cost)[1] | 2.9 | (3.0) | (0.1) |
| Statement of comprehensive income: | | | |
| Actuarial gains arising from experience adjustments | 12.9 | 1.0 | 13.9 |
| Actuarial losses arising from changes in financial assumptions | – | (11.1) | (11.1) |
| Contributions by employer | 2.8 | – | 2.8 |
| Benefits paid | (1.5) | 1.5 | – |
| At 31 December 2014 | 83.1 | (79.6) | 3.5 |

Note:

1. The income / (cost) in the income statement has been included under other operating expenses.

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

| | 2014 £m | 2013 £m | 2012 £m | 2011 £m | 2010 £m |
|---|---|---|---|---|---|
| Present value of defined benefit scheme obligations | (79.6) | (68.0) | (61.2) | (54.1) | (54.5) |
| Fair value of defined benefit scheme assets | 83.1 | 66.0 | 63.7 | 56.7 | 54.4 |
| Net surplus / (deficit) | 3.5 | (2.0) | 2.5 | 2.6 | (0.1) |
| Experience adjustment gains / (losses) on scheme liabilities | 1.0 | (0.2) | (0.1) | 0.4 | 0.5 |
| Experience adjustment gains / (losses) on scheme assets | 12.9 | (1.3) | 2.2 | (2.6) | 3.1 |

## 32. Retirement benefit obligations continued

### Sensitivity analysis

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

| | Impact on pension cost | | Impact on present value of defined benefit scheme obligations | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Discount rate** | | | | |
| 0.25% increase in discount rate | **(0.2)** | (0.2) | **(4.1)** | (3.5) |
| 0.25% decrease in discount rate | **0.1** | 0.1 | **4.1** | 3.6 |
| **Inflation rate** | | | | |
| 0.25% increase in inflation rate | **–** | – | **2.1** | 1.8 |
| 0.25% decrease in inflation rate | **–** | – | **(2.1)** | (1.8) |
| **Life expectancy** | | | | |
| 1 year increase in life expectancy | **0.1** | 0.1 | **1.8** | 1.5 |
| 1 year decrease in life expectancy | **(0.1)** | (0.1) | **(1.8)** | (1.6) |

The Group is currently undertaking a funding valuation of the defined benefit scheme at 1 October 2014, the results of which are due to be presented to the Group in 2015. The Group agreed with the trustees after the funding valuation of 1 October 2011 to make contributions of £2.8 million per annum until 2016 to meet the scheme's funding requirements. Any changes arising from the valuation at 1 October 2014 will be discussed with the trustees.

## 33. Share-based payments

The Group operates equity-settled, share-based compensation plans in the form of a Long-Term Incentive Plan, Restricted Shares Plan, Direct Line Group Share Incentive Plans, including both the Free Share awards and Buy-As-You-Earn Plan, and the Deferred Annual Incentive Plan, details of which are set out below together with their financial impact:

### Long-Term Incentive Plan

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

Awards were made in the year ended 31 December 2014 over 2.2 million Ordinary Shares with an estimated fair value at grant of £4.3 million in March 2014 (2013: 3.0 million Ordinary Shares with an estimated fair value at grant of £4.9 million) and 2.0 million Ordinary Shares with an estimated fair value at grant of £4.7 million in August 2014 (2013: 2.5 million Ordinary Shares with an estimated fair value at grant of £4.3 million).

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

The table below details the inputs into the model.

| | **2014** | 2013 |
|---|---|---|
| Weighted average assumptions during the year: | | |
| Share price | **270p** | 208p |
| Exercise price | **0p** | 0p |
| Volatility of Company share price | **26%** | 26% |
| Average comparator volatility | **30%** | 32% |
| Expected life | **3 years** | 3 years |
| Risk-free rate | **1.1%** | 0.5% |

As only limited historic data is available for the Group, expected volatility was determined by calculating the median historic volatility for a group of comparable companies using daily share price data over a period commensurate with the expected life assumption. These comparable companies are classified as being in the insurance sector in the FTSE 350.

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

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

### Restricted Shares Plan

The purpose of the Restricted Shares Plan is to enable share-based awards to be made to employees of the Group who are newly recruited and to enable ad-hoc share awards to existing employees. These awards can be granted at any time during the year, generally have no performance criteria attached and vest over periods ranging between one and three years from the date of the grant, subject to continued employment. During the year awards were made over 0.5 million Ordinary Shares (2013: nil) under this plan with an estimated fair value of £1.4 million (2013: nil) estimated using the market value at the date of grant.

### RBS Group LTIP awards

Prior to IPO in October 2012, certain employees benefited from share-based awards originally granted by RBS Group. RBS Group indemnified Direct Line Group for all future costs in respect of RBS Group share-based awards made to Direct Line Group employees. All costs in respect of these share awards for Direct Line Group employees have since been borne by RBS Group.

In accordance with the above, the RBS Group Remuneration Committee has agreed that RBS Group would be responsible for the settlement of the outstanding LTIP awards in the year ended 31 December 2012, expected to vest in March 2015, with no charge to be made to Direct Line Group. These 2012 LTIP awards will be settled with Company Ordinary Shares currently held by RBS Group. Further details of the RBS Group legacy share-based payments are set out in the Directors' remuneration report.

### Direct Line Group Share Incentive Plans – Free Share awards

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

In addition to the above, the Group announced its intention during December 2014 to offer a Free Share award with a value of £400 to all UK based employees. This award will be made during March 2015 and will be satisfied using market-purchased shares.

### Direct Line Group Share Incentive Plans – Buy-As-You-Earn Plan

The Buy-As-You-Earn Plan in the UK and an International plan for Italy, mirroring the UK plan, were both launched during the year ended 31 December 2013.

This plan entitles employees to purchase shares from pre-tax pay for between £10 and £125 per month, or Euro equivalent, and receive one matching share for every two shares purchased. The limit of £125 per month was subsequently increased to £150 per month in January 2015 following changes in legislation during 2014.

In the year ended 31 December 2014, matching share awards were granted over 0.3 million Ordinary Shares (2013: 0.3 million Ordinary Shares) with an estimated fair value of £0.8 million (2013: £0.6 million). The fair value of each matching share award is estimated using the market value at the date of grant.

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

### Deferred Annual Incentive Plan

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

In March 2014 awards were made over 1.1 million Ordinary Shares (2013: 1.1 million Ordinary Shares) under this plan with an estimated fair value of £2.6 million (2013: £2.2 million) estimated using the market value at the date of grant.

The awards outstanding at 31 December 2014 have no performance criteria attached, other than the requirement that the employee remains in employment with the Group for three years from the date of award.

## 33. Share-based payments continued

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

| | Number of share options million 2014 | Number of share options million 2013 |
|---|---|---|
| At 1 January | 11.4 | 5.1 |
| Granted during the year | 6.1 | 6.9 |
| Forfeited during the year | (0.8) | (0.4) |
| Exercised during the year | (0.3) | (0.2) |
| At 31 December | 16.4 | 11.4 |
| Exercisable at 31 December | 0.3 | 0.2 |

In respect of the outstanding options at 31 December 2014, the weighted average remaining contractual life is 1.66 years (2013: 2.20 years). No share options expired during the year (2013: nil).

The weighted average share price for awards exercised during the year ended 31 December 2014 was £2.56 (2013: £2.17).

The Group recognised total expenses in the year ended 31 December 2014 of £6.6 million (2013: £4.1 million) relating to equity-settled share-based compensation plans.

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

## 34. Trade and other payables including insurance payables

| | 2014 £m | 2013 £m |
|---|---|---|
| Due to agents, brokers and intermediaries | 19.3 | 6.2 |
| Due to reinsurers | 57.0 | 81.0 |
| Due to insurance companies | 5.3 | 13.6 |
| Due to related parties | – | 58.7 |
| Trade creditors and accruals | 342.8 | 255.8 |
| Other creditors | 96.5 | 174.3 |
| Other taxes | 55.0 | 80.6 |
| Provisions | 79.4 | 134.9 |
| Deferred income | 5.3 | 13.2 |
| Total[1] | 660.6 | 818.3 |

Note:

1. Included in the disposal group (note 5B) is £82.0 million which has been transferred from trade and other payables including insurance payables at 31 December 2014.

### Movement in provisions during the year

| | Regulatory levies £m | Restructuring £m | Other[1] £m | Total £m |
|---|---|---|---|---|
| At 1 January 2014 | 27.3 | 33.6 | 74.0 | 134.9 |
| Additional provision | 33.4 | 13.7 | 47.2 | 94.3 |
| Utilisation of provision | (34.2) | (31.4) | (43.7) | (109.3) |
| Released to income statement | – | (7.5) | (33.0) | (40.5) |
| At 31 December 2014 | 26.5 | 8.4 | 44.5 | 79.4 |

Note:

1. Other provisions include £1.9 million (2013: £22.5 million) for costs associated with onerous contracts in respect of leasehold properties.

## 35. Notes to the consolidated cash flow statement

| | 2014 £m | 2013 £m |
|---|---|---|
| **Profit for the year** | **372.6** | 312.8 |
| Adjustments for: | | |
| Investment income | **(191.0)** | (188.6) |
| Instalment income | **(105.2)** | (117.8) |
| Other operating losses | **6.6** | 0.7 |
| Investment property revaluations | **(26.4)** | (7.5) |
| Finance costs | **37.2** | 37.7 |
| Equity-settled share-based payment transactions | **6.6** | 4.1 |
| Tax charge | **105.2** | 111.1 |
| Depreciation and amortisation expenses | **84.8** | 58.2 |
| Impairment of property, plant and equipment, goodwill and intangible assets | **9.6** | 5.5 |
| Reversal of impairment losses on financial investments | **(1.3)** | – |
| Impairment movements on reinsurance contracts | **13.2** | (7.5) |
| Impairment losses on assets held for sale | **9.6** | – |
| Profit on sale of AFS financial investments | **(22.8)** | (25.7) |
| Loss on sale of property, plant and equipment | **0.3** | 2.9 |
| Profit on sale of investment property | **(2.3)** | – |
| Profit on disposal of subsidiary | **(2.3)** | (12.0) |
| **Operating cash flows before movements in working capital** | **294.4** | 173.9 |
| Movements in working capital: | | |
| Net decrease in net insurance liabilities including reinsurance assets and deferred acquisition costs | **(589.0)** | (594.8) |
| Net increase in prepayments and accrued income and other assets | **(19.1)** | (13.1) |
| Net decrease in insurance and other receivables | **59.2** | 34.3 |
| Net (decrease) / increase in trade and other payables including insurance payables | **(57.9)** | 175.9 |
| Contribution to retirement benefit obligations | **(2.8)** | (2.8) |
| **Cash used by operations** | **(315.2)** | (226.6) |
| Taxes paid | **(94.8)** | (80.2) |
| Cash flow hedges | **(0.6)** | (0.2) |
| **Net cash flow used by operating activities before investment of insurance assets** | **(410.6)** | (307.0) |
| Interest received | **358.5** | 574.2 |
| Rental income received from investment property | **16.2** | 11.4 |
| Purchases of investment property | **(76.2)** | (87.0) |
| Proceeds on disposal of investment property | **21.1** | – |
| Proceeds on disposal / maturity of AFS financial investments | **3,141.0** | 3,147.8 |
| Net decrease in investment loans and receivables | **304.8** | 209.3 |
| Purchases of AFS financial investments | **(2,644.3)** | (3,422.7) |
| **Cash generated from investment of insurance assets** | **1,121.1** | 433.0 |

## 36. Contingent liabilities

The Group did not have any contingent liabilities at 31 December 2014 (2013: none).

## 37. Commitments

### Operating lease commitments

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

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Minimum lease payments under operating leases recognised as an expense in the year | 25.6 | 32.2 |

The minimum lease payments under operating leases recognised as an expense in the year in relation to discontinued operations is £2.5 million (2013: £2.8 million).

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

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Within one year | 17.1 | 26.9 |
| In the second to fifth years inclusive | 55.1 | 78.6 |
| After five years | 176.2 | 241.1 |
| Total | 248.4 | 346.6 |

The outstanding commitments in relation to discontinued operations are £11.5 million (2013: £17.1 million) of which £1.6 million (2013: £2.9 million) is payable within one year, £5.4 million (2013: £6.4 million) is payable in the second to fifth years and £4.5 million (2013: £7.8 million) is payable after five years.

### Operating lease commitments where the Group is the lessor

The following table analyses future aggregate minimum lease payments receivable under non-cancellable operating leases in respect of property leased to third-party tenants.

| Continuing operations | 2014 £m | 2013 £m |
|---|---|---|
| Within one year | 14.6 | 13.3 |
| In the second to fifth years inclusive | 51.7 | 45.3 |
| After five years | 99.6 | 85.9 |
| Total | 165.9 | 144.5 |

There were no commitments by third parties to make lease payments to the Group's discontinued operations at 31 December 2014 (2013: £nil).

## 38. Fair value

The methodology adopted by the Group for fair value measurement of investment properties, financial assets and liabilities and the basis for determining fair value hierarchy are explained in note 2.3.

### Comparison of carrying value to fair value of financial instruments

The following table compares the carrying value and the fair value of financial instruments (excluding the disposal group – note 5B). Differences arise where the measurement basis of the asset or liability is not fair value (e.g. assets / liabilities carried at amortised cost).

| | Fair value 2014 £m | Carrying value 2014 £m | Fair value 2013 £m | Carrying value 2013 £m |
|---|---|---|---|---|
| **Financial assets** | | | | |
| Derivative assets (note 24) | 27.3 | 27.3 | 40.7 | 40.7 |
| AFS debt securities[1](note 25) | 5,830.3 | 5,830.3 | 7,005.5 | 7,005.5 |
| Deposits with credit institutions with maturities in excess of three months (note 25) | 54.7 | 54.7 | 435.7 | 435.7 |
| Infrastructure debt (note 25) | 76.0 | 76.2 | – | – |
| **Financial liabilities** | | | | |
| Subordinated liabilities (note 29) | 651.9 | 526.3 | 625.4 | 486.6 |
| Derivative liabilities (note 24) | 29.4 | 29.4 | 19.3 | 19.3 |

Note:

1. Included in the disposal group (note 5B) in 2014 are AFS debt securities with a fair value and carrying value of £706.9 million that are excluded from the AFS debt securities above.

Fair values of the following assets and liabilities (including assets and liabilities held in the disposal group – note 5B) approximate their carrying values:

- Insurance and other receivables
- Cash and cash equivalents
- Borrowings
- Trade and other payables including insurance payables (excluding provisions)

### Fair value hierarchy analysis

The following tables analyse the Group's assets and liabilities carried at fair value (excluding the disposal group – note 5B) by reference to the Group's fair value hierarchy.

| At 31 December 2014 | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| Investment property (note 19) | – | – | 307.2 | 307.2 |
| Derivative assets (note 24) | – | 27.3 | – | 27.3 |
| AFS debt securities[1](note 25) | 985.6 | 4,844.7 | – | 5,830.3 |
| **Total** | 985.6 | 4,872.0 | 307.2 | 6,164.8 |
| Derivative liabilities (note 24) | – | 29.4 | – | 29.4 |
| **Total** | – | 29.4 | – | 29.4 |

Note:

1. Included in the disposal group (note 5B) in 2014 are AFS debt securities of £706.9 million, that are excluded from the categorisation of AFS debt securities above, of which £31.9 million is categorised as level 1 and £675.0 million is categorised as level 2 within the fair value hierarchy.

| At 31 December 2013 | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| Investment property (note 19) | – | – | 223.4 | 223.4 |
| Derivative assets (note 24) | – | 40.7 | – | 40.7 |
| AFS debt securities (note 25) | 1,393.7 | 5,611.8 | – | 7,005.5 |
| **Total** | 1,393.7 | 5,652.5 | 223.4 | 7,269.6 |
| Derivative liabilities (note 24) | – | 19.3 | – | 19.3 |
| **Total** | – | 19.3 | – | 19.3 |

The movements in assets classified as Level 3 in the fair value hierarchy are all within Investment property which are analysed in note 19. There were no changes in the categorisation of assets between Levels 1, 2 and 3 during the year for assets and liabilities held at 31 December 2013.

## 39. Related parties

On 27 February 2014, RBS Group announced the completion of the sale of its remaining interest of 423.2 million Ordinary Shares in the Company.

RBS Group has now sold all its Ordinary Shares in the Company except for the shares held to satisfy long-term incentive plan awards granted by RBS Group to Direct Line Group management.

Transactions with RBS Group in the year ended 31 December 2014 were similar in nature to those for the year ended 31 December 2013. However, following the sale on 27 February 2014, transactions with RBS Group are no longer included in the tables below, as the related party relationship ceased from the sale date.

### Transactions with related parties

| | 2014 £m | 2013 £m |
|---|---|---|
| Sale of insurance contracts and other services | 0.3 | 3.2 |
| Purchase of services | 19.7 | 145.8 |

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

### Year end related balances arising from cash and investment transactions with related parties

| | 2014 £m | 2013 £m |
|---|---|---|
| Cash at bank | – | 64.7 |
| Bank overdrafts | – | (55.1) |
| Derivative financial assets | – | 20.0 |
| Derivative financial liabilities | – | (18.5) |
| Term deposits | – | 35.0 |
| AFS debt securities | – | 48.6 |
| Total | – | 94.7 |

### Year end balances arising from sales and purchases of products and services to and from related parties

| | Amounts owed by related parties | | Amounts owed to related parties | |
|---|---|---|---|---|
| | 2014 £m | 2013 £m | 2014 £m | 2013 £m |
| Total | 0.2 | 0.9 | 25.4 | 58.7 |

### Movement in amounts owed by / to related parties

| | Amounts owed by related parties | | Amounts owed to related parties | |
|---|---|---|---|---|
| | 2014 £m | 2013 £m | 2014 £m | 2013 £m |
| At 1 January | 0.9 | 5.1 | 58.7 | 34.7 |
| Transactions in the year | 0.1 | 0.2 | 19.1 | 147.1 |
| Settled in the year | (0.8) | (4.4) | (52.4) | (123.1) |
| At 31 December | 0.2 | 0.9 | 25.4 | 58.7 |

### Compensation of key management

| | 2014 £m | 2013 £m |
|---|---|---|
| Short-term employee benefits | 10.2 | 9.1 |
| Post-employment benefits | 0.3 | 0.2 |
| Termination benefits | 0.4 | 0.2 |
| Share-based payments | 3.4 | 1.9 |
| Total | 14.3 | 11.4 |

## 40. Post balance sheet events

On 13 January 2015 the Group announced its intention to close its sites at Pudsey and vacate the premises, with all roles being transferred to the Group's Leeds offices. These sites which are owned by the Group have been impaired in 2015 by approximately £22.0 million. Marketing of these sites will begin shortly.

## Parent Company balance sheet
As at 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Assets** | | | |
| Investment in subsidiary undertakings | 2 | 3,065.0 | 3,181.5 |
| Other receivables | 4 | 523.3 | 528.8 |
| Current tax assets | 5 | 1.2 | 1.6 |
| Derivative financial instruments | 6 | 2.4 | – |
| Financial investments | 7 | 5.1 | – |
| Cash and cash equivalents | 8 | 51.2 | 6.8 |
| Assets held for sale | 3 | 114.8 | – |
| **Total assets** | | 3,763.0 | 3,718.7 |
| **Equity** | | | |
| Share capital | 9 | 150.0 | 150.0 |
| Capital redemption reserve | | 1,450.0 | 1,450.0 |
| Share-based payment reserve | | 9.5 | 3.9 |
| Cash flow hedging reserve | | 1.2 | – |
| Retained earnings | | 1,647.5 | 1,611.9 |
| **Total equity** | | 3,258.2 | 3,215.8 |
| **Liabilities** | | | |
| Subordinated liabilities | 10 | 503.1 | 502.4 |
| Derivative financial instruments | 6 | 0.6 | – |
| Trade and other payables | 11 | 1.1 | 0.5 |
| **Total liabilities** | | 504.8 | 502.9 |
| **Total equity and liabilities** | | 3,763.0 | 3,718.7 |

The attached notes on pages 163 to 166 form an integral part of these separate financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 2 March 2015. They were signed on its behalf by:

**John Reizenstein**
Chief Financial Officer

Direct Line Insurance Group plc

Registration No. 02280426

## Parent Company statement of comprehensive income
For the year ended 31 December 2014

| | 2014 £m | 2013 £m |
|---|---|---|
| **Profit for the year** | **436.7** | 193.1 |
| **Other comprehensive income** | | |
| **Items that may be reclassified subsequently to income statement:** | | |
| Cash flow hedges | **1.2** | – |
| **Other comprehensive income net of tax** | **1.2** | – |
| **Total comprehensive income for the year attributable to owners of the Company** | **437.9** | 193.1 |

## Parent Company statement of changes in equity
For the year ended 31 December 2014

| | Share capital £m | Capital reserves £m | Share-based payment reserve £m | Foreign exchange translation reserve £m | Retained earnings £m | Total shareholder equity £m |
|---|---|---|---|---|---|---|
| **Balance at 1 January 2013** | 150.0 | 1,450.0 | 0.3 | – | 1,661.5 | 3,261.8 |
| Total comprehensive income for the year | – | – | – | – | 193.1 | 193.1 |
| Dividends paid | – | – | – | – | (242.7) | (242.7) |
| Credit to equity for equity-settled share-based payments | – | – | 4.1 | – | – | 4.1 |
| Shares distributed by employee trusts | – | – | (0.5) | – | – | (0.5) |
| **Balance at 31 December 2013** | 150.0 | 1,450.0 | 3.9 | – | 1,611.9 | 3,215.8 |
| Total comprehensive income for the year | **–** | **–** | **–** | **1.2** | **436.7** | **437.9** |
| Dividends paid | **–** | **–** | **–** | **–** | **(401.1)** | **(401.1)** |
| Credit to equity for equity-settled share-based payments | **–** | **–** | **6.6** | **–** | **–** | **6.6** |
| Shares distributed by employee trusts | **–** | **–** | **(1.0)** | **–** | **–** | **(1.0)** |
| **Balance at 31 December 2014** | **150.0** | **1,450.0** | **9.5** | **1.2** | **1,647.5** | **3,258.2** |

## Parent Company cash flow statement
For the year ended 31 December 2014

| | Notes | 2014 £m | 2013 £m |
|---|---|---|---|
| **Net cash used by operating activities** | 13 | **(0.1)** | (3.0) |
| **Cash flows from investing activities** | | | |
| Interest received on loans to subsidiary undertakings | | **47.6** | 47.5 |
| Dividends received from subsidiary undertakings | | **446.7** | 220.8 |
| Acquisition of investments in subsidiary undertakings | | **–** | (9.1) |
| Disposal of investments in subsidiary undertakings | 2 | **2.7** | 39.3 |
| Cash flows from net investment hedges | | **–** | (5.3) |
| Purchase of AFS financial investments | | **(5.1)** | – |
| **Net cash generated from investing activities** | | **491.9** | 293.2 |
| **Cash flows from financing activities** | | | |
| Dividends paid | | **(401.1)** | (242.7) |
| Finance costs | | **(46.3)** | (46.3) |
| Repayment of borrowings from related parties | | **–** | (255.0) |
| Net increase in loans advanced to subsidiary undertakings | | **–** | (7.7) |
| **Net cash used by financing activities** | | **(447.4)** | (551.7) |
| **Net increase / (decrease) in cash and cash equivalents** | | **44.4** | (261.5) |
| Cash and cash equivalents at the beginning of the year | 8 | **6.8** | 268.3 |
| **Cash and cash equivalents at the end of the year** | 8 | **51.2** | 6.8 |

The attached notes on pages 163 to 166 form an integral part of these separate financial statements

## 1. Accounting policies

### 1.1 Basis of preparation

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

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

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

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

### 1.2 Investment in subsidiaries

Investment in subsidiaries is stated at cost less any impairment.

### 1.3 Dividend income

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

## 2. Investment in subsidiary undertakings

| | 2014 £m | 2013 £m |
|---|---|---|
| At 1 January | 3,181.5 | 3,226.1 |
| Additions | 6.6 | 13.2 |
| Disposals | (4.0) | (50.7) |
| Impairments | (4.3) | (10.8) |
| Effect of foreign currency exchange adjustment | – | 3.7 |
| Transfer to assets held for sale | (114.8) | – |
| At 31 December | 3,065.0 | 3,181.5 |

The Company sold 100% of the share capital of its subsidiary Tracker Network (UK) Limited on 5 February 2014. The carrying value of the investment in Tracker was £4.0 million at the date of sale. The total cash consideration received was £2.7 million generating a loss on disposal of £1.3 million.

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

Full details of investments in principal subsidiaries are set out in note 20 to the consolidated financial statements.

## 3. Assets held for sale

| | 2014 £m | 2013 £m |
|---|---|---|
| Investment in subsidiary undertaking | 114.8 | – |

On 25 September 2014, the Company entered into a binding agreement for the sale, subject to regulatory approval, of its German subsidiary Direct Line Versicherung AG for a cash consideration of €292.0 million (£228.3 million).

## 4. Other receivables

| | 2014 £m | 2013 £m |
|---|---|---|
| Loans to subsidiary undertakings[1] | 518.9 | 528.8 |
| Receivables from subsidiary undertakings | 2.9 | – |
| Other debtors | 1.5 | – |
| **Total** | 523.3 | 528.8 |
| Current | 23.3 | 28.8 |
| Non-current | 500.0 | 500.0 |
| **Total** | 523.3 | 528.8 |

Note:

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

## 5. Current tax assets

| | 2014 £m | 2013 £m |
|---|---|---|
| **Corporation tax recoverable** | 1.2 | 1.6 |

## 6. Derivative financial instruments

| | Notional Amount | Fair Value |
|---|---|---|
| | 2014 £m | 2014 £m |
| **Derivative assets** | | |
| Designated as hedging instruments – third parties | 435.6 | 2.4 |
| **Derivative liabilities** | | |
| Designated as hedging instruments – subsidiary undertakings | 8.3 | 0.6 |

The Company entered into a foreign currency hedge contract in September 2014, converting Euro to Pounds Sterling, in relation to the proposed sale of the International business. The Company has also entered into foreign exchange hedge contracts relating to supplier payments on behalf of its Group subsidiaries. The Company had no derivative financial instruments at 31 December 2013.

## 7. Financial investments

| | 2014 £m | 2013 £m |
|---|---|---|
| **AFS debt securities** | 5.1 | – |

## 8. Cash and cash equivalents

| | 2014 £m | 2013 £m |
|---|---|---|
| Cash at bank and in hand | 0.1 | 0.1 |
| Short-term deposits with credit institutions | 51.1 | 6.7 |
| **Total** | 51.2 | 6.8 |

## 9. Share capital

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

## 10. Subordinated liabilities

| | 2014 £m | 2013 £m |
|---|---|---|
| **Subordinated guaranteed dated notes** | **503.1** | 502.4 |

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

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

The notes are guaranteed by U K Insurance Limited, a principal subsidiary of the Company.

The Company has the option in certain circumstances, to defer interest payments on the notes but to date has not exercised this right.

The aggregate fair value of subordinated guaranteed dated notes is £651.9 million (2013: £625.4 million).

## 11. Trade and other payables

| | 2014 £m | 2013 £m |
|---|---|---|
| Payables to subsidiary undertakings | 1.0 | 0.5 |
| Payables to third parties | 0.1 | – |
| **Total** | 1.1 | 0.5 |

## 12. Dividends

Full details of the dividends paid and proposed by the Company are set out in note 15 to the consolidated financial statements.

## 13. Cash generated from operations

| | 2014 £m | 2013 £m |
|---|---|---|
| **Profit for the year** | **436.7** | 193.1 |
| Adjustments for: | | |
| Impairment in subsidiary undertakings | 4.3 | 10.8 |
| Investment income | (494.5) | (268.4) |
| Other operating gains | (0.6) | (0.2) |
| Finance costs | 46.9 | 47.1 |
| Loss on disposal of subsidiary undertakings | 1.3 | 11.4 |
| Tax credit | (1.2) | (1.3) |
| **Operating cash flows before movements in working capital** | (7.1) | (7.5) |
| Movements in working capital: | | |
| Net decrease in other receivables | 4.8 | 0.8 |
| Net increase in trade and other payables | 0.6 | – |
| Tax received | 1.6 | 4.2 |
| Finance costs | – | (0.5) |
| **Cash used by operations** | (0.1) | (3.0) |

## 14. Related parties

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

On 27 February 2014 RBS Group announced the completion of the sale of its remaining interest of 423.2 million Ordinary Shares in the Company.

RBS Group has now sold all its Ordinary Shares in Direct Line Group except for the shares held to satisfy long-term incentive plan awards granted by RBS Group to Direct Line Group management. Full details of related parties are set out in note 39 to the consolidated financial statements.

The following transactions were carried out with related parties:

### Sales of services

| | 2014 £m | 2013 £m |
|---|---|---|
| Interest received from subsidiary undertakings | 47.6 | 47.4 |
| Dividend income from subsidiary undertakings | 446.7 | 220.8 |

Interest income from loans to subsidiary undertakings was charged at rates ranging from 0.5% to 9.50% (2013: 0.5% to 9.50%).

### Purchases of services

| | 2014 £m | 2013 £m |
|---|---|---|
| Management fees payable to subsidiary undertakings | 7.3 | 7.7 |
| Interest payable to subsidiary undertakings | – | 0.1 |
| Total | 7.3 | 7.8 |

Interest charged on borrowings from related parties were at rates ranging from 0.5% to 0.6% (2013: 0.5% to 2.0%).

## 15. Share-based payments

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

## 16. Risk management

The risks faced by the Company are considered to be from its investment in subsidiaries. The Company also holds, on behalf of its subsidiaries, designated hedging instruments which relate to the sale of the Group's International business and foreign currency supplier payments.

Its risks are considered to be the same as those in the operations of the Group itself and details of the key risks to the Group and the steps taken to manage them are disclosed in note 3 to the consolidated financial statements.

## 17. Directors and key management remuneration

The Directors and key management of the Group and the Company are the same. The aggregate emoluments of the Directors are set out in note 11 to the consolidated financial statements, the compensation for key management is set out in note 39 to the consolidated financial statements and the remuneration and pension benefits payable in respect of the highest paid Director, are included in the Directors' remuneration report in the Governance section of the Annual Report & Accounts.

## Corporate website

The Group's corporate website is www.directlinegroup.com. It contains additional useful information for the Company's investors and shareholders, including press releases, forthcoming events, essential shareholder information, dividend history, a financial calendar, and details of the Company's AGM. You can also subscribe for email news alerts.

## Market

The Company has a premium listing on the UK Listing Authority's Official List. The Company's Ordinary Shares, exchange price information code ("**EPIC**"): DLG, are admitted to trading on the London Stock Exchange.

## Share ownership

### Share capital

You can find details of the Company's share capital in note 27 to the consolidated financial statements.

### Dividends

The Group aims to generate long-term sustainable value for shareholders, while balancing operational, regulatory, rating agency and policyholder requirements. The Board has adopted a progressive dividend policy for the Company. This will aim to increase the dividend annually in real terms to reflect its cash flow generation and long-term earnings potential.

It is expected that one-third of the annual dividend will generally be paid in the third quarter as an interim dividend, and two-thirds will be paid as a final dividend in the second quarter of the following year. The Board may revise the dividend policy from time to time.

Additionally, if the Board believes the Group has capital surplus to the Board's view of its requirements, it is intended that such excess capital will be returned to shareholders. The Company may consider a special dividend and/or a repurchase of its own shares to distribute surplus capital to shareholders.

The Company pays its dividends in Pounds Sterling to shareholders registered on its register of members at the relevant record date.

Shareholders may have their cash dividends paid directly into a bank or building society by completing a dividend mandate form. This is available from the Company's registrar, Computershare Investor Services PLC ("**Registrar**"), in the UK. You can find the Registrar's contact details on page 172. Alternatively, shareholders may access their shareholdings online and download a dividend mandate form from the Investor Centre. You can find details of this on page 172.

### Dividend Reinvestment Plan

The Company offers a Dividend Reinvestment Plan ("**DRIP**") that gives shareholders the opportunity to use their cash dividends to buy the Company's Ordinary Shares in the market. You can find further details on the Company's website.

## Shareholder enquiries

Shareholders with queries on any matter relating to their shares can contact our Registrar using the contact details listed on page 172 of this Annual Report & Accounts.

Shareholders should notify the Registrar of any change in shareholding details, such as their address, as soon as possible.

Shareholders can also access their current shareholding details online at www.investorcentre.co.uk/directline . Investor Centre is a free-to-use, secure, self-service website that enables shareholders to manage their holdings online. The website allows shareholders to:

- Check their holdings
- Update their records (including address and direct credit details)
- Access all their securities in one portfolio by setting up a personal account
- Vote online
- Register to receive electronic shareholder communications

The website requires shareholders to quote their Shareholder Reference Number, which can be found on their share certificate, to access this information.

## Shareholder warning

Five thousand people contact the FCA about share fraud each year, with victims losing an average of £20,000.

Fraudsters use persuasive and high-pressure tactics to lure investors into scams. They may offer to sell shares that transpire to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment. While high profits are promised, if you buy or sell shares in this way, you will probably lose your money.

### How to avoid share fraud

- Remember that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares
- Do not start conversing with them. Note the name of the person and firm contacting you, then end the call
- Check the Financial Services Register at www.fca.org.uk to see if the person and firm contacting you are authorised by the FCA
- Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details
- Use the firm's contact details listed on the Register if you want to call them back
- Call the FCA on 0800 111 6768 if the firm does not have contact details on the Register or you are told they are out of date
- Search the list of unauthorised firms to avoid at www.fca.org.uk/scams

- Consider that if you buy or sell shares from an unauthorised firm, you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme
- Think about getting independent financial and professional advice before you hand over any money
- Remember, if it sounds too good to be true, it probably is

**Report a scam**

If fraudsters approach you, please tell the FCA using the share fraud reporting form at www.fca.org.uk/scams . This web page also provides more information about investment scams.

You can also call the FCA Consumer Helpline on 0800 111 6768.

If you have already paid money to share fraudsters, contact Action Fraud on 0300 123 2040.

## Tips on how you can protect your shares

- Keep all your certificates in a safe place. Alternatively, consider holding your shares in the UK's electronic registration and settlement system for equity, CREST, or via a nominee
- Keep correspondence from the Registrar that shows your shareholder reference number in a safe place, and shred unwanted correspondence
- Inform the Registrar as soon as you change your address
- If you receive a letter from the Registrar regarding a change of address and you have not recently moved, contact them immediately
- Be aware of when the dividends are paid and contact the Registrar if you do not receive your dividend
- Consider having your dividends paid directly into your bank account. You will need to fill out a dividend mandate form and send it to the Registrar. This reduces the risk of cheques being stolen or lost in the post
- If you change your bank account, inform the Registrar of your new account details immediately
- If you are buying or selling shares, deal only with brokers registered in the UK or in your country of residence
- Be aware that the Company will never call you concerning investment matters. If you receive such a call from a person purporting to represent the Company, please contact the Company Secretary immediately

## Electronic communications and voting

The Group produces a range of communications which shareholders can view online, download or receive a paper copy by contacting the Registrar. You can find the Registrar's contact details on page 172.

Shareholders who register their email address with our Registrar or at the Investor Centre can learn of events by email, such as the AGM, and receive shareholder communications like the Annual Report & Accounts, and Notice of Meeting.

## Dealing facilities

Shareholders can buy, sell or transfer their shares through a stockbroker or a high street bank, or through the Registrar's share dealing facility.

You can call or email the Registrar regarding its share-dealing facility using the following contact information:

- For telephone sales, call +44 (0)870 703 0084 between 8.30 am and 5.30 pm, Monday to Friday, excluding public holidays
- For internet sales log on to www.investorcentre.co.uk/directline. You will need your Shareholder Reference Number as shown on your share certificate or your welcome letter from the Chairman

## Financial calendar

2015

| Date | Event |
|---|---|
| 3 March | Preliminary Results Announcement 2014 |
| 12 March | 'Ex-dividend' date for 2014 interim[1] and second special interim dividends |
| 13 March | Record date for 2014 interim[1] and second special interim dividends |
| 17 April | Payment date for 2014 interim[1] and second special dividends |
| 6 May[2] | Interim Management Statement for the first quarter of 2015 |
| 13 May | Annual General Meeting |
| 4 August[2] | Half Year Report 2015 |
| 13 August[2] | 'Ex-dividend' date for 2015 interim dividend |
| 14 August[2] | Record date for 2015 interim dividend |
| 11 September[2] | Payment date for 2015 interim dividend |
| 3 November[2] | Interim Management Statement for the third quarter of 2015 |

## Annual General Meeting

The 2015 AGM will be held on 13 May 2015 at The Auditorium, Allen & Overy LLP, One Bishops Square, London E1 6AD, starting at 11.00 am. All shareholders will receive a separate notice convening the AGM, which will explain the resolutions to be put to the meeting.

Note:

1. The Board has resolved this year to pay an interim dividend in lieu of a final dividend.
2. These dates are subject to change.

# Glossary

| Term | Definition |
|---|---|
| Actuarial best estimate | The probability-weighted average of all future claims and cost scenarios calculated using historical data, actuarial methods and judgement. A best estimate of reserves will therefore normally be designed to include no margin for optimism or, conversely, caution. |
| AIP | Annual Incentive Plan |
| Available-for-sale ("**AFS**") investment | Financial assets that are classified as available for sale. Please refer to the accounting policy note 1.12 on page 111. |
| BAYE | Buy-As-You-Earn |
| Capital | The funds invested in the Group, including funds invested by shareholders and retained profits. |
| Claims frequency | The number of claims divided by the number of policies per year. |
| Claims reserve (provision for losses and loss-adjustment expense) | Funds the Group sets aside to meet the estimated cost of claims payments and related expenses that the Group considers it will ultimately need to pay. |
| Clawback | The ability of the Company to claim repayment of paid amounts. |
| Combined operating ratio ("**COR**") | The sum of the loss, expense and commission ratios. The ratio is a measure of the amount of claims costs and expenses compared to net earned premium generated. A ratio of less than 100% indicates profitable business. |
| Commission | Amounts paid to brokers, partners and PCWs for generating business. |
| Commission ratio | The ratio of commission expense divided by net earned premium. |
| Current-year attritional loss ratio | The loss ratio for the current accident year, excluding the impact of movement of claims reserves relating to previous accident years, and claims relating to major weather events in the Home division. |
| DAIP | Deferred Annual Incentive Plan |
| Discontinued operations | The Group reached a binding agreement with Mapfre, S.A. to sell the Group's International division, see notes 1 and 5 to the consolidated financial statements, on pages 108 and 133 respectively. |
| DL4B | Direct Line for Business is an extension of the Direct Line brand. It is our direct commercial insurance brand for small-sized businesses in the UK that have straightforward commercial insurance requirements. |
| Earnings per share | The amount of the Group's profit allocated to each Ordinary Share of the Company. |
| ERB | Employee Representative Body |
| Expense ratio | The ratio of operating expenses divided by net earned premium. |
| Finance costs | The cost of servicing the Group's external borrowings. |
| Financial Conduct Authority ("**FCA**") | The independent body that regulates firms and financial advisers. It helps put the interests of customers and the integrity of the market at the core of what insurance, and other financial service, providers do. |
| FRC | Financial Reporting Council |
| Gross written premium | The total premiums from contracts that began during the period. |
| IASB | International Accounting Standards Board |
| Incurred but not reported ("**IBNR**") | Funds set aside to meet the cost of claims for accidents that have taken place, but have not yet been reported to us. |
| Incurred loss | Claims that have been paid plus claims advised by a policyholder, but not yet paid. Does not include IBNR, see above. |
| ICA | Individual capital assessment |
| ICAS | Individual capital adequacy standards |
| ICAS+ | Introduced by the PRA in 2013, ICAS+ is an extension of the ICAS regime. It allows firms to use their developing Solvency II frameworks, particularly the internal model. |
| In-force policies | The number of policies on a given date that are active and against which the Group will pay, following a valid insurance claim. |
| Initial public offering ("**IPO**") | The first sale of shares by a previously unlisted company to investors on a securities exchange. |
| Insurance reserves | This comprises insurance liabilities and the liability-adequacy reserve. Together, these amount to the reserves an insurance company maintains to meet current and future claims. |

| Term | Definition |
|---|---|
| Investment income yield | The annualised investment income earned through the income statement during the period, divided by the average assets under management ("**AUM**") for each asset class during the same period. Investment income excludes unrealised and realised gains and losses, impairments and fair-value adjustments, while the average AUM for the period is derived from the period's opening and closing balances. |
| Investment return | The income earned from the investment portfolio. This includes unrealised and realised gains and losses, impairments and fair-value adjustments. |
| Investment return yield | The total annualised investment return earned through the income statement during the period. This includes items such as unrealised and realised gains and losses, impairments and fair-value adjustments, divided by the average AUM for each asset class during the same period. |
| Loss ratio | Net insurance claims divided by net earned premium. |
| LTIP | Long-Term Incentive Plan |
| Malus | An arrangement that permits the forfeiture of unvested remuneration awards, in circumstances the Company considers appropriate. |
| Net asset value | The net asset value of the Group is calculated by subtracting total liabilities from total assets. |
| Net claims | The cost of claims incurred in the period less any claims costs recovered under reinsurance contracts. It includes claims payments and movements in claims reserves. |
| Net earned premium | The element of gross earned premium less reinsurance premium ceded for the period where insurance cover has already been provided. |
| Ogden discount rate | The discount rate set by the relevant government bodies, the Lord Chancellor and Scottish Ministers, and used to calculate lump-sum awards in bodily injury cases. |
| Ongoing operations | Includes the Group's ongoing segments: Motor, Home, Rescue and other personal lines, and Commercial. It excludes the International division, the Run-off segment and restructuring and other one-off costs. |
| Operating profit | The pre-tax profit generated by the Group's activities, including insurance and investment activity, but excluding finance costs. |
| ORSA | Own Risk and Solvency Assessment |
| Periodic payment order ("**PPO**") | These are claims payments as awarded under the Courts Act 2003. PPOs are used to settle large personal injury claims. They generally provide claimants who require long-term care with a lump sum award plus inflation-linked annual payments. |
| Prudential Regulation Authority ("**PRA**") | The Prudential Regulation Authority is a part of the Bank of England. It is responsible for the prudential regulation and supervision of insurers and financial institutions in the UK. |
| RBS Group | The Royal Bank of Scotland Group plc and its subsidiary companies. |
| Reinsurance | Contractual arrangements where the Group transfers part or all of the insurance risk accepted to another insurer. |
| Reserves | Funds that have been set aside to meet outstanding insurance claims and IBNR. |
| Return on equity | Return on equity is calculated by dividing the profit attributable to the owners of the Company by average ordinary shareholders' equity for the period. |
| Return on tangible equity ("**RoTE**") | Return on tangible equity is adjusted profit after tax from ongoing operations divided by the Group's average shareholders' equity less goodwill and other intangible assets. Profit after tax is adjusted to exclude the International division, which is classified as discontinued operations, the Run-off segment and restructuring and other one-off costs, and is stated after charging tax (using the UK standard tax rate). |
| Risk mix | Risk mix reflects the expected level of claims from the portfolio. It measures the estimated movement based on risk models used in that period and is revised when risk models are updated. |
| Run-off | Where the Group no longer underwrites new business, but continues to meet its claims liabilities under existing contracts. |
| SME | Small and medium-sized enterprises |
| Solvency II | The proposed capital adequacy regime for the European insurance industry to become effective on 1 January 2016, which establishes a revised set of EU-wide capital requirements and risk-management standards. It comprises three pillars: Pillar I, which sets out capital requirements for an insurer; Pillar II, which focuses on systems of governance; and Pillar III, which deals with disclosure requirements. |
| Total Shareholder Return ("**TSR**") | Compares the movement in the share price together with reinvested dividends as a percentage of the share price at the beginning of the period. |
| Underwriting result (profit / loss) | The profit or loss from operational activities, excluding investment performance. It is calculated as net earned premium less net insurance claims and total expenses. |

## Forward-looking statements disclaimer

This Annual Report & Accounts has been prepared for, and only for, the members of the Company as a body, and no other persons. The Company, its Directors, employees, agents or advisers do not accept responsibility to any other person to whom this document is shown or into whose hands it may come and any such responsibility or liability is expressly disclaimed.

Certain information contained in this document, including any information as to the Group's strategy, plans or future financial or operating performance, constitutes "forward-looking statements". These forward-looking statements may be identified by the use of forward-looking terminology, including the terms "aims", "anticipates", "aspire", "believes", "continue", "could", "estimates", "expects", "guidance", "intends", "may", "outlook", "plans", "predicts", "projects", "seeks", "should", "targets" or "will" or, in each case, their negative or other variations or comparable terminology, or by discussions of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this document and include statements regarding the intentions, beliefs or current expectations of the Directors concerning, among other things: the Group's results of operations, financial condition, prospects, growth, strategies and the industry in which the Group operates. Examples of forward-looking statements include financial targets which are contained in this document specifically with respect to RoTE, risk-based capital coverage ratio, the Group's COR and cost savings. By their nature, all forward-looking statements involve risk and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future or are beyond the Group's control.

Forward-looking statements are not guarantees of future performance. The Group's actual results of operations, financial condition and the development of the business sector in which the Group operates may differ materially from those suggested by the forward-looking statements contained in this document, for example directly or indirectly as a result of, but not limited to, UK domestic and global economic business conditions, market-related risks such as fluctuations in interest rates and exchange rates, the policies and actions of regulatory authorities (including changes related to capital and solvency requirements or the Ogden discount rate), the impact of competition, currency changes, inflation and deflation, the timing impact and other uncertainties of future acquisitions, disposals, joint ventures or combinations within relevant industries, as well as the impact of tax and other legislation and other regulation in the jurisdictions in which the Group and its affiliates operate. In addition, even if the Group's actual results of operations, financial condition and the development of the business sector in which the Group operates are consistent with the forward-looking statements contained in this document, those results or developments may not be indicative of results or developments in subsequent periods.

The forward-looking statements contained in this document reflect knowledge and information available as of the date of preparation of this document. The Group and the Directors expressly disclaim any obligations or undertaking to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, unless required to do so by applicable law or regulation. Nothing in this document should be construed as a profit forecast.

Neither the content of Direct Line Group's website nor the content of any other website accessible from hyperlinks on the Group's website is incorporated into, or forms part of, this document.

# Contact information

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# **More** information

In conjunction with this report, we have produced a separate online version of key sections.

For more information, go to ara2014.directlinegroup.com

Our app houses the most up-to-date financial information about the Group which includes the following sections:

- Results and presentations
- Share price information
- Financial calendar
- Company and regulatory news

To download the app search Direct Line Group Investor Relations

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