PROSPECTUS dated 25 April 2012

Direct Line Insurance Group plc

(incorporated in England and Wales with limited liability with registered number 02280426)

£500,000,000

Fixed/Floating Rate Guaranteed Subordinated Notes due 2042 guaranteed by

U K Insurance Limited

(incorporated in England and Wales with limited liability with registered number 01179980)

Issue Price: 99.200 per cent.

The £500,000,000 Fixed/Floating Rate Guaranteed Subordinated Notes due 2042 guaranteed by U K Insurance Limited (the "**Guarantor**" or "**U K Insurance**") on a subordinated basis (the "**Notes**") will be issued by Direct Line Insurance Group plc (the "**Issuer**" or the "**Company**" and, together with its consolidated subsidiaries, the "**Group**") (formerly RBS Insurance Group Limited) on or about 27 April 2012 (the "**Issue Date**"). The Notes will bear interest from (and including) the Issue Date to (but excluding) 27 April 2022 (the "**First Call Date**") at a fixed rate of 9.250 per cent. per annum and thereafter at a floating rate of 7.910 per cent. per annum above the six month London interbank offered rate. Interest will be payable on the Notes semi-annually in arrear on each Interest Payment Date, commencing 27 October 2012, provided that the Issuer may defer payments of interest on any Optional Interest Payment Date, and must defer payments of interest (i) on any Mandatory Interest Deferral Date and/or (ii) if such payment could not be made in compliance with the Issuer Solvency Condition. Any interest which is deferred (and not paid by the Guarantor) will, for so long as it remains unpaid, constitute "**Arrears of Interest**". Arrears of Interest will not themselves bear interest, and will be payable as provided in Condition 6.

Subject to the following proviso, the Notes will (unless previously redeemed or purchased and cancelled) mature on the Interest Payment Date falling in April 2042 (the "**Maturity Date**"), and may be redeemed at the option of the Issuer on any Interest Payment Date falling on or after the First Call Date, or prior to such date (i) following the occurrence of (or if the Issuer satisfies the Trustee that there will occur within six months) a Capital Disqualification Event or a Ratings Methodology Event (provided that, in the case of a Ratings Methodology Event, the Notes will not be redeemed prior to the fifth anniversary of the Issue Date) or (ii) in the event of certain changes in the tax treatment applicable to the Notes, provided that redemption of the Notes on the Maturity Date or any other date set for redemption of the Notes shall be deferred if (a) a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing on such date, or would occur if the Notes were to be redeemed, or (b) the Notes could not be redeemed in compliance with the Issuer Solvency Condition. The Issuer may, alternatively, following the occurrence of (or if the Issuer satisfies the Trustee that there will occur within six months) a Capital Disqualification Event or a Ratings Methodology Event or in the event of certain changes in the tax treatment applicable to the Notes, vary or substitute the Notes in the circumstances described in Condition 8. Any substitution or variation of the Notes, and any redemption or purchase of the Notes prior to the Maturity Date, will be subject to satisfaction of the Regulatory Clearance Condition and continued compliance with applicable Regulatory Capital Requirements as published by the Financial Services Authority (or any successor authority, the "**FSA**"), all as more particularly described in Condition 8.9.

Application has been made to the FSA in its capacity as competent authority under the Financial Services and Markets Act 2000 (as amended, the "**FSMA**") for the Notes to be admitted to the official list of the UK Listing Authority (the "**Official List**") and to the London Stock Exchange plc (the "**London Stock Exchange**") for the Notes to be admitted to trading on the London Stock Exchange's Regulated Market (the "**Market**"). References in this Prospectus to the Notes being "**listed**" (and all related references) shall mean that the Notes have been admitted to the Official List and have been admitted to trading on the Market. The Market is a regulated market for the purposes of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments.

Potential investors should read the whole of this document, in particular the "Risk Factors" set out on pages 13 to 42.

The Notes have been rated BBB+ by Standard & Poor's Credit Market Services Europe Limited ("**Standard & Poor's**") and Baa1 by Moody's Investors Service Limited ("**Moody's**"). Standard & Poor's and Moody's are each credit rating agencies established in the European Union and registered under Regulation (EC) No 1060/2009 and each of them is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

Structuring Adviser

THE ROYAL BANK OF SCOTLAND

Joint Bookrunners & Joint Lead Managers

CITIGROUP **HSBC** **THE ROYAL BANK OF SCOTLAND**

This Prospectus comprises a prospectus for the purposes of Article 5.3 of Directive 2003/71/EC (the "**Prospectus Directive**").

The Issuer and the Guarantor (the "**Responsible Persons**") accept responsibility for the information contained in this Prospectus. To the best of the knowledge of the Issuer and the Guarantor (each having taken all reasonable care to ensure that such is the case) the information contained in this Prospectus is in accordance with the facts and does not omit anything likely to affect the import of such information.

The Accountant's Report set out on pages F-3 to F-4 of this Prospectus (the "**Accountant's Report**") has been prepared by Deloitte LLP, Chartered Accountants, at the request of the Issuer. Deloitte LLP has given and has not withdrawn its written consent to the inclusion in this Prospectus of the Accountant's Report in the form and context in which it appears in this Prospectus and has authorised those parts of this Prospectus which comprise its Accountant's Report for the purposes of item 5.5.4R(2)(f) of the Prospectus Rules.

Neither the Managers (as described under "*Subscription and Sale*" below) nor the Trustee have independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Managers or the Trustee as to the accuracy or completeness of the information contained or incorporated in this Prospectus or any other information provided by the Issuer or the Guarantor in connection with the offering of the Notes. No Manager or the Trustee accepts any liability in relation to the information contained in this Prospectus or any other information provided by the Issuer or the Guarantor in connection with the offering of the Notes or their distribution.

No person is or has been authorised by the Issuer, the Guarantor, the Managers or the Trustee to give any information or to make any representation not contained in or not consistent with this Prospectus or any other information supplied in connection with the offering of the Notes and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the Guarantor, any of the Managers or the Trustee.

Neither this Prospectus nor any other information supplied in connection with the offering of the Notes (a) is intended to provide the basis of any credit or other evaluation or (b) should be considered as a recommendation by the Issuer, the Guarantor, any of the Managers or the Trustee that any recipient of this Prospectus or any other information supplied in connection with the offering of the Notes should purchase any Notes. Each investor contemplating purchasing any Notes should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer and the Guarantor. Neither this Prospectus nor any other information supplied in connection with the offering of the Notes constitutes an offer or invitation by or on behalf of the Issuer or the Guarantor, any of the Managers or the Trustee to any person to subscribe for or to purchase any Notes in any jurisdiction where such offer or invitation is not permitted by law.

Neither the delivery of this Prospectus nor the offering, sale or delivery of the Notes shall in any circumstances imply that the information contained herein concerning the Issuer and/or the Guarantor is correct at any time subsequent to the date hereof or that any other information supplied in connection with the offering of the Notes is correct as of any time subsequent to the date indicated in the document containing the same. The Managers and the Trustee expressly do not undertake to review the financial condition or affairs of the Issuer or the Guarantor during the life of the Notes or to advise any investor in the Notes of any information coming to their attention.

Neither the Notes nor the guarantee in respect thereof have been nor will be registered under the United States Securities Act of 1933, as amended (the "**Securities Act**"). Subject to certain exceptions, the Notes may not be offered, sold or delivered within the United States or to U.S. persons. For a further description of certain restrictions on the offering and sale of the Notes and on distribution of this document, see "*Subscription and Sale*" below.

The Notes may not be a suitable investment for all investors. Each potential investor in the Notes must determine the suitability of the investment in light of its own circumstances. In particular, each potential investor should (a) have sufficient knowledge and experience to make a meaningful evaluation of the Notes, the merits and risks of investing in the Notes and the information contained in this Prospectus or any applicable supplement; (b) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Notes and the impact such investment will have on its overall investment portfolio; (c) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Notes, including where the currency for principal or interest payments is different from the potential investor's currency; (d) understand thoroughly the terms of the Notes and be familiar with the behaviour of any relevant indices and financial markets; and (e) be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

The Notes are complex financial instruments. Such instruments may be considered by investors who are in a position to be able to satisfy themselves that the Notes would constitute an understood, measured, appropriate addition of risk to their overall portfolios. A potential investor should not invest in the Notes unless it has the expertise (either alone or with the help of a financial adviser) to evaluate how the Notes will perform under changing conditions, the resulting effects on the value of the Notes and the impact this investment will have on the potential investor's overall investment portfolio.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy the Notes in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Prospectus and the offer or sale of Notes may be restricted by law in certain jurisdictions. The Issuer, the Guarantor, the Managers and the Trustee do not represent that this Prospectus may be lawfully distributed, or that the Notes may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Guarantor, the Managers or the Trustee which is intended to permit a public offering of the Notes or the distribution of this Prospectus in any jurisdiction where action for that purpose is required. Accordingly, no Notes may be offered or sold, directly or indirectly, and neither this Prospectus nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Prospectus or any Notes may come must inform themselves about, and observe, any such restrictions on the distribution of this Prospectus and the offering and sale of Notes. In particular, there are restrictions on the distribution of this Prospectus and the offer or sale of Notes in the United States and the United Kingdom, see "*Subscription and Sale*".

IN CONNECTION WITH THE ISSUE OF THE NOTES, THE ROYAL BANK OF SCOTLAND PLC AS STABILISING MANAGER (THE "STABILISING MANAGER") (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) MAY OVER-ALLOT NOTES OR EFFECT TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF THE NOTES AT A LEVEL HIGHER THAN THAT WHICH MIGHT OTHERWISE PREVAIL. HOWEVER, THERE IS NO ASSURANCE THAT THE STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) WILL UNDERTAKE STABILISATION ACTION. ANY STABILISATION ACTION MAY BEGIN ON OR AFTER THE DATE ON WHICH ADEQUATE PUBLIC DISCLOSURE OF THE TERMS OF THE OFFER OF THE NOTES IS MADE AND, IF BEGUN, MAY BE ENDED AT ANY TIME, BUT IT MUST END NO LATER THAN THE EARLIER OF 30 DAYS AFTER THE ISSUE DATE OF THE NOTES AND 60 DAYS AFTER THE DATE OF THE ALLOTMENT OF THE NOTES. ANY STABILISATION ACTION OR OVER-ALLOTMENT MUST BE CONDUCTED BY THE STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) IN ACCORDANCE WITH ALL APPLICABLE LAWS AND RULES.

All references in this document to "**sterling**" and "**£**" refer to the currency of the United Kingdom, references to "**US dollars**" means United States dollars and references to "**euro**" refer to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty on the Functioning of the European Union, as amended.

FORWARD-LOOKING STATEMENTS

This document contains certain "forward-looking statements". Statements that are not historical facts, including statements about the Issuer's, the Guarantor's and/or their respective directors' and/or management's beliefs and expectations are forward-looking statements. Words such as "believes", "anticipates", "estimates", "expects", "intends", "plans", "aims", "potential", "will", "would", "could", "considered", "likely", "estimate" and variations of these words and similar future or conditional expressions, are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend upon future circumstances that may or may not occur, many of which are beyond the Group's control and all of which are based on the Group's current beliefs and expectations about future events. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements of the Issuer, the Guarantor or the Group, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such forward-looking statements are based on numerous assumptions regarding the Issuer, the Guarantor and the Group's present and future business strategies and the environment in which the Group will operate in the future. These forward-looking statements speak only as at the date of this document. Except as required by the FSA, the London Stock Exchange, the Listing Rules, the Prospectus Rules, the Disclosure and Transparency Rules or any other applicable law or regulation, the Issuer and the Guarantor expressly disclaim any obligations or undertaking to release publicly any updates or revisions to any forward-looking statements contained in this document to reflect any change in the Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

PRESENTATION OF FINANCIAL INFORMATION

Historical financial information

The historical financial information for the three years ended 31 December 2011, set out on pages F-5 to F-88 of this Prospectus (the "**Historical Financial Information**"), has been prepared on the basis set out on page F-2 and Deloitte LLP has provided an accountant's report with respect to such financial information on pages F-3 to F-4 of this Prospectus. The Historical Financial Information is different to the financial information for the insurance division of the RBS Group (the "**RBSG Insurance Division**") incorporated in the RBS Group's financial results disclosures. Differences arise principally because:

- a number of items, including restructuring costs, separation costs and goodwill impairment, are recorded before operating profit within the Historical Financial Information but not included in the RBSG Insurance Division's operating profit reported within the RBS Group's financial results disclosures; and
- the operating results of the activities of Tesco Personal Finance is reflected in operating profit in the Historical Financial Information as a run-off business of the Group, but does not constitute core operating profit for the purposes of the RBS Group's financial results disclosures, and as a result the Tesco Personal Finance operating results are included as part of the non-core portion of the RBS Group's financial results disclosures and not in the results for the RBSG Insurance Division.

As a result, the Historical Financial Information is not directly comparable with previous financial information for the RBSG Insurance Division incorporated in the RBS Group's financial results disclosures. Investors should consider only the Historical Financial Information as contained within this Prospectus when making any investment decision relating to the Notes. Investors should not rely on or base their decision on the previous or future financial results disclosures of the RBS Group or any other source.

Adjusted return on equity

The Group uses adjusted return on equity as a supplemental measure of its performance and believes it is relevant to the evaluation of companies in its industry. The Group calculates adjusted return on equity as adjusted operating profit after tax divided by average tangible ordinary shareholders equity. Profit after tax is adjusted to exclude run-off businesses and restructuring costs, and the application of the Group's standard tax rate for the relevant year or period. The unadjusted return on equity is calculated as profit after tax divided by average ordinary shareholders equity. Adjusted return on equity is not a measurement of performance under IFRS and investors should not consider this measure as an alternative to other measures of performance under IFRS. This information has been disclosed in this Prospectus to permit a more complete and comprehensive analysis of the Group's operating performance relative to other companies. Because all companies do not calculate these measures identically, the Group's presentation of this measure may not be comparable to similarly titled measures of other companies.

MARKET AND INDUSTRY INFORMATION

This document contains information regarding the Group's business and the industry in which it operates and competes. The Issuer obtained this information from various third party sources, discussions with the Group's customers and the Group's own internal estimates. In certain cases, the Issuer has made statements on the basis of information obtained from third party sources that management believes are reliable, including:

- Datamonitor, Industry Profile: Motor Insurance in the United Kingdom (2011);
- Datamonitor, Industry Profile: Motor Insurance in Germany (2011);
- Datamonitor, Industry Profile: Motor Insurance in Italy (2011);
- *Associazione Nazionale fra le Imprese Assicuratrici, Premi del lavoro diretto italiano* 2010 (2011);
- Association of British Insurers, Rankings by Class based on UK Gross Written Premiums in 2010 (2011);
- Mintel Group Ltd, Vehicle Recovery—UK (2011);
- Nunwood Brand Tracking, Motor and Home Top 3 Box Consideration Scores (March 2011 to February 2012); and
- GfK NOP Financial Research Survey (FRS) 3 months ending December 2011, 8,000 adults interviewed.

Industry publications, surveys and forecasts generally state that the information contained therein has been obtained from sources believed to be reliable. None of the Issuer, the Guarantor and the Managers have independently verified these industry publications, surveys and forecasts and, therefore, none of them can guarantee their accuracy or completeness.

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OVERVIEW OF THE PRINCIPAL FEATURES OF THE NOTES

*The following overview refers to certain provisions of the conditions of the Notes and the Trust Deed and is qualified by the more detailed information contained elsewhere in this Prospectus. Capitalised terms which are defined in "Conditions of the Notes" have the same meaning when used in this overview. References to numbered Conditions are to the conditions of the Notes (the "**Conditions**") as set out under "Conditions of the Notes".*

Issuer	Direct Line Insurance Group plc.
Guarantor	U K Insurance Limited.
Trustee	BNY Mellon Corporate Trustee Services Limited.
Issue	£500,000,000 Fixed/Floating Rate Guaranteed Subordinated Notes due 2042.
Risk Factors	There are certain factors that may affect the Issuer's ability to fulfil its obligations under the Notes and the Guarantor's ability to fulfil its obligations under the Guarantee. In addition, there are certain factors which are material for the purpose of assessing the market risks associated with the Notes and certain risks relating to the structure of the Notes. These are set out under "*Risk Factors*".
Status and Subordination	The Notes constitute unsecured, subordinated obligations of the Issuer, and will rank *pari passu* without any preference among themselves. The rights and claims of the Noteholders against the Issuer are subordinated in a winding-up of the Issuer as described in Condition 3.2. In addition, all payments under or arising from the Notes and the Trust Deed shall be conditional upon the Issuer being solvent (as that term is described in Condition 3.4) at the time for payment by the Issuer, and no amount shall be payable by the Issuer under or arising from the Notes and the Trust Deed unless and until such time as the Issuer could make such payment and still be solvent immediately thereafter.
Guarantee	The Notes will be irrevocably and unconditionally guaranteed on a subordinated basis by the Guarantor. The rights and claims of Noteholders against the Guarantor are subordinated in a winding-up of the Guarantor as described in Condition 4.3. In addition, all payments under or arising from the Guarantee shall be conditional upon the Guarantor being solvent (as that term is described in Condition 4.6) at the time for payment by the Guarantor, and no amount shall be payable under or arising from the Guarantee unless and until such time as the Guarantor could make such payment and still be solvent immediately thereafter. For the purpose only of determining whether any Guaranteed Amount is from time to time due and payable by the Issuer for the purposes of the obligations of the Guarantor under the Guarantee, any amount of principal, interest and Arrears of Interest shall be deemed to be due and payable by the Issuer on the applicable date regardless of whether the Issuer Solvency Condition is satisfied or whether the Issuer has deferred payment of such amounts in accordance with the Conditions.

Interest	The Notes will bear interest from (and including) the Issue Date to (but excluding) the First Call Date at a fixed rate of 9.250 per cent. per annum payable (subject as provided under "*Deferral of interest*" below) semi-annually in arrear on 27 April and 27 October in each year. Thereafter, the Notes will bear interest at a floating rate of 7.910 per cent. per annum above the six month London interbank offered rate payable (subject as provided under "*Deferral of interest*" below) semi-annually in arrear on 27 April and 27 October in each year, subject to adjustment in accordance with the modified following business day convention.
Deferral of interest	The Issuer may, on any Optional Interest Payment Date, elect to defer payments of interest on the Notes. The Issuer is required to defer any payment of interest on the Notes (i) on each Mandatory Interest Deferral Date (being an Interest Payment Date in respect of which a Regulatory Deficiency Interest Deferral Event has occurred and is continuing) or (ii) if such payment could not be made in compliance with the Issuer Solvency Condition. The Guarantor may, on any Guarantor Optional Interest Payment Date, elect to defer payments of Guaranteed Amounts in respect of interest on the Notes. The Guarantor is required to defer payments of Guaranteed Amounts in respect of interest on the Notes (i) on each Guarantor Mandatory Interest Deferral Date (being an Interest Payment Date in respect of which a Guarantor Regulatory Deficiency Interest Deferral Event has occurred and is continuing) or (ii) if such payment could not be made in compliance with the Guarantor Solvency Condition.
Arrears of Interest	Any interest which is deferred by the Issuer and the Guarantor will, for so long as it remains unpaid, constitute Arrears of Interest. Arrears of Interest will not themselves bear interest, and will be payable by the Issuer as provided in Condition 6.7 or by the Guarantor as provided in Condition 6.8.
Redemption at maturity	Unless previously redeemed or purchased and cancelled, the Issuer will (subject as provided under "*Deferral of redemption*" below) redeem the Notes on the Interest Payment Date falling in April 2042.
Early redemption	The Issuer may, subject as provided under "*Deferral of redemption*" below, upon giving not less than 15 nor more than 30 days' notice to Noteholders, redeem all (but not some only) of the Notes on the First Call Date or any Interest Payment Date thereafter at their principal amount together with any Arrears of Interest and any other accrued but unpaid interest to (but excluding) the date of redemption. The Notes are not redeemable at the option of any Noteholder.

Redemption, substitution or variation upon a relevant tax law change . . . If:

(a) as a result of a change in, or amendment to, certain tax laws or regulations or the official interpretation thereof, on the next Interest Payment Date, (i) the Issuer would be required to pay additional amounts on the Notes as provided in Condition 9; or (ii) the Guarantor would be unable for reasons outside its control to procure payment by the Issuer and in making payment itself would be required to pay such additional amounts; or (iii) the payment of interest (or any Guaranteed Amounts in respect of interest) would be treated as a "distribution" for United Kingdom tax purposes; or (iv) in respect of the payment of interest (or any Guaranteed Amounts in respect of interest), the Issuer or the Guarantor, as the case may be, would not to any material extent be entitled to have any attributable loss or non-trading deficit set against the profits of companies with which it is grouped for applicable United Kingdom tax purposes (whether under the group relief system current as at the Issue Date or any similar system or systems having like effect as may from time to time exist); and

(b) the effect of the foregoing cannot be avoided by the Issuer or, as the case may be, the Guarantor by taking reasonable measures available to it,

the Issuer may, in accordance with Condition 8.6, upon notice to Noteholders either:

(A) redeem all (but not some only) of the Notes at any time at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest to (but excluding) the date of redemption (subject as provided under "*Deferral of redemption*" below); or

(B) substitute all (but not some only) of the Notes for, or vary the terms of the Notes so that they become or remain, Qualifying Dated Tier 2 Securities,

all as more particularly described in Condition 8.6.

Redemption, substitution or variation upon a Capital Disqualification Event or a Ratings Methodology Event . . . . If a Capital Disqualification Event or a Ratings Methodology Event has occurred and is continuing, or the Issuer satisfies the Trustee that, as a result of any change in, or amendment to, or any change in the application or official interpretation of, any applicable law, regulation, ratings methodology or other official publication, the same will occur within a period of six months, the Issuer may upon notice to Noteholders either:

(a) redeem all (but not some only) of the Notes at any time (in the case of a Capital Disqualification Event) or at any time on or after the fifth anniversary of the Issue Date (in the case of a Ratings Methodology Event) at their principal amount, together with any Arrears of Interest and any other accrued and unpaid interest to (but excluding) the date of redemption (subject as provided under "*Deferral of redemption*" below); or

	(b) substitute the Notes for, or vary the terms of the Notes so that they become or remain, Qualifying Dated Tier 2 Securities (in the case of a Capital Disqualification Event) or Rating Agency Compliant Securities (in the case of a Ratings Methodology Event),
	all as more particularly described in Condition 8.7.
Deferral of redemption	No Notes shall be redeemed by the Issuer on the Maturity Date or on any other date set for redemption pursuant to Conditions 8.5, 8.6 or 8.7 if (i) a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if the Notes were to be redeemed, or (ii) such redemption could not be made in compliance with the Issuer Solvency Condition. In addition, the obligations of the Guarantor under the Guarantee to make payment of Guaranteed Amounts in respect of principal, interest or any other amount in relation to the redemption of the Notes will be mandatorily deferred if (i) a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if such payment is made, or (ii) such payment could not be made in compliance with the Guarantor Solvency Condition. If redemption of the Notes is deferred, the Issuer will redeem the Notes as provided in Condition 8.2 or the Guarantor will pay the Guaranteed Amounts in respect of the redemption of the Notes as provided in Condition 8.3.
Regulatory approval for early redemption, variation, substitution or purchase	Prior to publishing any notice (a) that the Issuer intends to redeem the Notes before the Maturity Date or (b) of any proposed substitution, variation or purchase of the Notes, the Issuer, or as the case may be, the Guarantor will be required to have complied with the Regulatory Clearance Condition with respect to such redemption, variation, substitution or purchase and be in continued compliance with Regulatory Capital Requirements as published by the FSA.
Withholding tax and additional amounts	The Issuer or, as the case may be, the Guarantor will pay such additional amounts as may be necessary in order that the net payment received by each Noteholder in respect of the Notes, after withholding or deduction for, or on account of, any taxes required by law in the United Kingdom upon payments made by or on behalf of the Issuer in respect of the Notes or by or on behalf of the Guarantor under the Guarantee, will equal the amount which would have been received in the absence of any such withholding or deduction, subject to customary exceptions as set out in Condition 9.

In the event of a withholding or deduction as required pursuant to an agreement described in Section 1471(b) of the U.S. Internal Revenue Code of 1986 (the "**Code**") or otherwise imposed pursuant to Sections 1471 through 1474 of the Code and any regulations or agreements thereunder, official interpretations thereof, or any law implementing an intergovernmental approach thereto, neither the Issuer nor the Guarantor, nor any paying agent or any other person, will be required to pay additional amounts as a result of such withholding or deduction.

Events of Default . . . . *Issuer*

If default is made by the Issuer for a period of 7 days or more in the payment of any interest or principal due in respect of the Notes or any of them, or an Issuer Winding-Up occurs, the Trustee on behalf of the Noteholders may (and, subject to certain conditions, if so directed by the requisite majority of Noteholders shall) institute proceedings for the winding-up of the Issuer in England and Wales (but not elsewhere), and/or (as applicable) prove in, the winding-up or administration of the Issuer but may take no further action to enforce, prove or claim for any payment by the Issuer in respect of the Notes or the Trust Deed.

Upon the occurrence of an Issuer Winding-Up, the Trustee may (and, subject to certain conditions, if so directed by the requisite majority of the Noteholders shall) give notice to the Issuer that the Notes are, and they shall accordingly become, immediately due and payable by the Issuer at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest, but the Guarantor's obligations with respect to payments under the Guarantee shall be as provided in Condition 4.5.

Guarantor

If default is made by the Guarantor for a period of 7 days or more in the payment of any amount due under the Guarantee, or a Guarantor Winding-Up occurs, the Trustee on behalf of the Noteholders may (and, subject to certain conditions, if so directed by the requisite majority of the Noteholders shall) institute proceedings for the winding-up of the Guarantor in England and Wales (but not elsewhere), and/or (as applicable) prove in, the winding-up or administration of the Guarantor but may take no further action to enforce, prove or claim for any payment by the Guarantor in respect of the Notes or the Trust Deed (including the Guarantee).

Upon the occurrence of a Guarantor Winding-Up, there shall be due and payable by the Guarantor an amount equal to the principal amount of the Notes together with any Arrears of Interest and any other accrued and unpaid interest, but the Notes shall not thereby become immediately due and repayable by the Issuer.

No amounts shall be due for payment by the Issuer under the Notes or the Trust Deed or due for payment by the Guarantor under the Guarantee where payment of such amounts has been deferred by the Issuer and/or the Guarantor, as the case may be, in accordance with the Conditions.

Substitution of obligor and transfer of business . . . . The Conditions permit the Trustee to agree to the substitution in place of the Issuer or the Guarantor of a Substitute Obligor in the circumstances described in Condition 14 without the consent of Noteholders.

In addition, the Guarantor may, without any prior approval from the Noteholders or the Trustee, transfer a substantial part (being any part which represents 50 per cent. or more of the liabilities (where the amount of the liabilities of the Guarantor is deemed to mean the same as the technical provisions of the Guarantor, net of reinsurance) relating to policies underwritten by the Guarantor) of its business in the circumstances provided in Condition 16, provided that all the liabilities and obligations of the Guarantor as principal obligor under the Guarantee are transferred to the relevant transferee.

Meetings of Noteholders . . . . The Conditions contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority.

Form . . . . The Notes will be issued in registered form and represented upon issue by a registered global certificate (the "**Global Certificate**") which will be registered in the name of a nominee for a common depositary for Clearstream Banking, *société anonyme* and Euroclear Bank S.A./N.V. on or about 27 April 2012. Save in limited circumstances, Notes in definitive form will not be issued in exchange for interests in the Global Certificate (see the section of this Prospectus entitled "*The Global Certificate*").

Denomination . . . . The denomination of the Notes shall be £100,000 and higher integral multiples of £1,000.

Listing . . . . Application has been made to the FSA in its capacity as competent authority under FSMA for the Notes to be admitted to the Official List and to the London Stock Exchange for such Notes to be admitted to trading on the Market.

Ratings . . . . The Notes have been rated BBB+ by Standard & Poor's and Baa1 by Moody's. Standard & Poor's and Moody's are each credit rating agencies established in the European Union and registered under Regulation (EC) No 1060/2009 and each of them is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

Governing law . . . . The Notes and the Trust Deed (including the Guarantee), and any non-contractual obligations arising out of or in connection with the Notes or the Trust Deed (including the Guarantee), will be governed by, and construed in accordance with, English law.

RISK FACTORS

The Issuer and the Guarantor believe that the following factors may affect their ability to fulfil their obligations under the Notes and the Guarantee, respectively. All of these factors are contingencies which may or may not occur and the Issuer and the Guarantor are not in a position to express a view on the likelihood of any such contingency occurring.

Factors which the Issuer and the Guarantor believe may be material for the purpose of assessing the market risks associated with the Notes are also described below. Any of these factors, individually or in the aggregate, could have an adverse effect on the Group's business, results of operations and financial position. In addition, many of these factors are correlated and may require changes to the Group's capital requirements, and events described therein could therefore have a compounding adverse effect on the Group.

The Issuer and the Guarantor believe that the factors described below represent the principal risks inherent in investing in the Notes, but the Issuer and/or the Guarantor may be unable to pay interest, principal or other amounts on or in connection with the Notes for other reasons and neither the Issuer nor the Guarantor represents that the statements below regarding the risks of holding the Notes are exhaustive. Prospective investors should also read the detailed information set out elsewhere in this Prospectus and reach their own views prior to making any investment decision.

RISKS RELATING TO THE GROUP

The Group's technical reserves may not adequately cover actual claims

Due to the uncertain nature and timing of the risks which the Group incurs in underwriting insurance products, it cannot precisely determine the amounts that it will ultimately pay to meet the liabilities covered by the insurance policies underwritten or when those liabilities will be paid. As such, the Group's technical reserves may prove to be inadequate to cover actual claims costs, particularly when the settlement of liability or payments of claims may not occur until well into the future, for example, and in particular, for bodily injury claims.

The Group maintains technical reserves to cover the estimated cost of future claims payments and related administrative expenses, with respect to losses or injuries which have been incurred but have not been fully settled at the balance sheet date or which may occur in the future against insurance policies which have already been written prior to the balance sheet date. This includes losses or injuries that have been reported to the Group and those that have not yet been reported. The technical reserves maintained by the Group represent estimates of all expected future payments, including related administrative expenses, to bring every claim (whether reported or not) which has occurred prior to the balance sheet date to final settlement. The Group's premium reserves represent the higher of unexpired premiums or the estimated ultimate cost of the Group's exposure to claims and expenses occurring after the balance sheet date against business which was written prior to such date.

The Group estimates technical reserves using a range of actuarial and statistical projections and assumptions across a range of variables such as the time required to learn of and settle claims, facts and circumstances known at a given time, estimates of trends, trends in the number of claims or claims of certain types, inflation in claims severity and expected future claims payment patterns. Estimates are also dependent on other variable factors including the legal, social, economic and regulatory environments, results of litigation, rehabilitation and mortality trends, business mix, consumer behaviour, market trends, underwriting assumptions, risk pricing models, inflation in medical care costs, future earnings inflation and other relevant forms of inflation, exchange rate movements, the cost of repairs and replacement, and estimated future receipts from third parties such as other insurers and reinsurance recoveries as well as changes in internal claims handling processes. The inevitable variations in any of these factors help to drive the uncertainty in the technical reserves estimate. While most of the Group's technical reserves are held on an undiscounted basis and, therefore, do not allow for the investment income which will be earned on the technical reserves after the balance sheet date up until the claims are fully settled, the technical reserves held in respect of periodic payment orders ("**PPOs**") are held on a discounted basis. As such, the size and nature of the PPO reserves are also exposed to the risk of changes in mortality, cost of care and other inflation, the timing of future cash flows or level of investment income. The Group's employers' liability business is also exposed to the risk of disease related claims in respect of currently unknown exposures being identified at a future date.

For claims, especially those which take several years to settle, such as bodily injury, illness, and public and employers' liability, it has been necessary historically, and may over time continue to be necessary, for the Group to revise its estimates of the total costs to settle the claims and, therefore, adjust its related technical reserves.

The Group's technical reserves are particularly susceptible to potential retrospective changes in legislation and new court decisions. For example, a change in the 'Ogden discount rate', which is the discount rate set by the UK government and used (among other things) by courts to calculate lump sum awards in bodily injury cases, would impact all relevant claims settled after that date, regardless of whether the insurance to which the claim relates was priced on that basis or not. Changes to the Ogden discount rate can result from changes in or volatility of interest rates, and there is a particular risk that sustained low interest rates may lead to increased pressure to reduce the Ogden discount rate. A reduction in the Ogden discount rate would have the effect of increasing the present value of lump sum awards, thereby increasing the amount the Group would need to pay to settle certain claims.

The award of PPOs to settle bodily injury claims, in which annually indexed payments are made periodically over several years or even the lifetime of the injured party, could also increase. Any changes in the propensity for claimants to settle bodily injury claims using a PPO relative to the estimates made when setting the technical reserves would have a similarly retrospective effect. The recent increase in the utilisation of PPOs to settle bodily injury claims makes the estimation of technical reserves increasingly complex and uncertain due to the increased range of assumptions required, such as the future propensity of such settlement methods, estimated rates of inflation, estimated mortality trends for impaired lives, payment patterns, investment income and the impact of reinsurance recoveries which will occur many years into the future with a resultant increase in the associated credit or other non-payment risk. The fact that these claims take many years to ultimately settle increases the uncertainty around their estimation, which could have a material adverse effect on the Group's business, results of operations and financial position, particularly because of the increasing proportion of claims reserves that the board of directors of the Company (the "**Board**") believes these claims will represent in the future.

Consequently, changes in any of these trends or other variable factors, including risks around the accuracy of the data used to estimate the technical reserves, may result in actual future claims costs and related expenses paid differing, potentially significantly, from the estimates reflected in the claims and premium reserves in the Group's financial statements. To the extent that the Group's technical reserves are subsequently estimated to be insufficient to cover the future cost of claims or administrative expenses, it will have to increase its technical reserves and incur a corresponding reduction in its earnings/net income in the period in which the deficiency is identified. In addition, if the Group's technical reserves are excessive as a result of an over-estimation of risk, it may set premiums at levels which are too high and potentially may not be able to compete effectively, which may result in a loss of customers and premium income. Conversely, if the Group charges premiums that are insufficient for the cover provided, it will suffer underwriting losses, leading to a reduction in earnings. Both of these could have a material adverse effect on its current and future business, results of operations and financial position. Any increase in the technical reserves held and/or estimates or expectations of the uncertainty around those technical reserves could also lead to increased capital being required and increased uncertainty around the Group's current and future profitability.

The Group's underwriting assumptions and risk pricing models may not reflect its overall risk exposure

The Group's results depend significantly on whether its actual claims and expense experience, in terms of ultimate cost and timing of cash flows, is consistent with the assumptions and pricing models it has used in underwriting and setting prices for its products. These assumptions are based on a variety of factors which may include historical data, estimates, assumptions or individual expert judgements in respect of known or potential future changes and statistical projections of what the Group believes will be the costs and cash flows of its liabilities. If the Group's actual claims and expense experience differ from the underlying assumptions and estimates it used in establishing such liabilities or pricing its business, or if the Group's pricing is different to the market price for similar insurance products, this would have an adverse affect on the Group's revenue generation, profit and financial position. In 2009 and 2010, the Group experienced a significant increase in bodily injury claims resulting in part from the rise of claims management companies, an increase in no-win/no-fee litigation, and an increase in PPOs, all of which contributed to significant financial underperformance, as the Group's underwriting and pricing assumptions had not taken into account these developments at the time the risk was priced.

Statistical methods, models or individual expert judgements may not accurately quantify the Group's risk exposure, including if circumstances arise that were not observed in the historical data or if the data otherwise proves to be inaccurate or inappropriate. In addition, the statistical methods, models or individual judgements themselves may be flawed, leading to inaccurate pricing of risk despite access to accurate data and accurate assessment of other risks. The Group's ability to quantify risk exposure, and as a result price insurance products successfully, is subject to risks and uncertainties including, without limitation: exposure to claims inflation; changes in claims frequency; unanticipated legal and regulatory changes and costs; changes in mortality or rehabilitation trends; assumptions on weather trends; unexpected or new types of claims; changes in social or market trends, including customer and claimant behaviour; changes in economic conditions; potential inaccuracies in the data collected from internal or external parties and/or used within the modelling and pricing processes; incorrect or incomplete analysis of data; potentially inaccurate or inappropriate policy terms and conditions; inappropriate or incomplete purchase of reinsurance or receipt of recoveries therefrom; changes in the internal operating environment within the Group; the selection of inappropriate pricing methodologies; and the uncertainties inherent in estimates and assumptions, including those used throughout the pricing and underwriting processes.

The actual claims payments may vary, perhaps significantly, from those estimated both in amount and in timing of payments, particularly if the payments occur well into the future. This may have a material adverse effect on the Group's business, results of operations and financial position and it may be necessary for the Group to increase prices for future insurance policies and to set aside additional reserves for existing, previously written policies, as well as increasing the capital it will be required to hold due to the increased uncertainty around future profitability.

The Group may fail to execute its ongoing transformation plan and/or the expected benefits of that plan may not be achieved

Following a period of underperformance, which led the Group to increase its reserves in 2009 and 2010, in the second half of 2009 the Group began implementing a range of measures aimed at improving its longer term financial performance, including increasing premiums, exiting unprofitable business lines (such as fleet, taxi and personal lines business sold via brokers), and enhancing its reserving processes and reducing costs. The Group is also in the process of upgrading and enhancing many of its operational processes and systems, including enhancing its enterprise risk management framework that is intended to integrate its risk, business and capital strategies (see "*The Issuer and the Group—Description of the Business of the Issuer and the Group—Risk Management—Enterprise-wide risk management framework*" on page 97).

The measures that have been implemented to date have helped position the Group, at the end of 2011, to commence the next stage of its transformation plan with the aim of achieving enhanced pricing accuracy, improved claims handling and additional cost savings in future periods, as well as strengthening risk and capital management. The Group also expects to commence initiatives aimed at further improving the skills and capabilities of its people. The performance and effectiveness of the new systems and processes, however, are currently unknown and may not deliver the expected benefits to the Group, and could lead to significant disruptions to the Group's operations. Furthermore, the successful implementation of additional initiatives is contingent upon a range of factors, both internally driven, such as the ability of the organisation to effectively and appropriately implement IT or business change, and those which are beyond the Group's control, including market conditions, the general business environment, regulation (including unexpected regulatory change), the activities of its competitors and consumers and the legal and political environment.

There can be no assurance that the Group will be able to achieve its financial or operational targets or realise all or part of the benefits that it expects from its current transformation plan or other future initiatives. The Group may be unable to implement one or more of its initiatives successfully, in whole or in part, may experience unexpected cost increases that more than offset any savings that it may achieve or may suffer from changes in the external environment that erode any potential benefits. Given the continued competitive pricing pressures experienced in the Group's industry, the Group's failure to realise cost savings and other such benefits would adversely affect the Group's business, results of operations and financial position.

The Group's results depend on the performance of its investment portfolio, and changes in the financial markets may have a significant adverse effect on the value of the Group's investment portfolio

The Group's investment returns, which are a significant contributor to the Group's profitability in any given year, are highly susceptible to changes in interest rates and credit spreads. The Group's investment returns are subject to a variety of risks, including risks related to general global economic conditions (including those in the eurozone), market volatility and interest rate fluctuations, liquidity risk, and credit risk. Changes in these factors can be very difficult to predict. For more information on the Group's investment portfolio, see "*The Issuer and the Group—Description of the Business of the Issuer and the Group—Investments*".

The value of the Group's fixed income portfolio will be affected by markets in interest rates, changes in the credit ratings of the issuers of the securities, and liquidity generally in the bond markets, which may affect returns on, and the market values of, UK and international fixed-income investments in the Group's investment portfolios. Generally, investment income may be reduced during sustained periods of lower interest rates as higher yielding fixed-income securities are called, mature or are sold and the proceeds reinvested at lower rates, even though prices of fixed-income securities tend to be higher and gains realised upon their sale tend to increase under such circumstances. During periods of rising interest rates, prices of fixed income securities tend to fall and realised gains upon their sale are reduced or realised losses are increased, but reinvestments take place at a higher yield. When the credit rating of the issuer of the debt securities falls, or the credit spread with respect to the issuer increases, the value of the fixed income securities may also decline. A substantial part of the Group's fixed income securities are classified as "available for sale" in its accounts, such that changes in asset values attributable to interest rate and credit changes are reflected on the Group's balance sheet. Changes to the amortised cost resulting from changes in currency exchange rates in which the Group's fixed income securities are held are reflected in the Group's income statement, whereas currency changes that impact the fair value of the Group's investment assets are reflected in the Group's balance sheet.

The Group is directly and indirectly exposed to the credit of sovereign states, financial services institutions and other sectors such as utilities. In particular, the Group's fixed income portfolio contains a number of debt instruments issued by UK and European financial services institutions, two of the largest holdings of which, as at 31 December 2011, were issued by the Lloyds Banking Group and the RBS Group, as well as sovereign states, including the United Kingdom. See "*—The Group's business is concentrated in the United Kingdom*". The value of those instruments has been and may continue to be adversely affected by developments in the global sovereign debt markets and the global economy as a whole. While the Group currently only has material sovereign related exposure to securities issued by the United Kingdom, it also holds securities issued by certain other European governments, most notably France. In addition, there can be no guarantee that it will not have more varied exposure in the future, that it will not incur losses as a result of indirect exposure, or that the risks associated with its direct holdings will not increase as a result of adverse changes in the sovereign debt markets.

The Group's investment portfolio also contains interest-rate-sensitive instruments that may be adversely affected by changes in interest rates, particularly its cash holdings (a significant proportion of which are held with the RBS Group). Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions, and other factors beyond the Group's control. The Group may not be able to appropriately or effectively mitigate interest rate sensitivity in a changing interest rate environment. In particular, a significant increase in interest rates could result in significant losses, realised or unrealised, in the fair value of the Group's current investment portfolio and, consequently, could have an adverse effect on its results of operations and capital position. Lower interest rates could also affect income derived from fixed income investments as borrowers seek to refinance at lower interest rates, redeeming current debt instruments and requiring the Group to reinvest the proceeds in securities with lower interest yields. A changing interest rate environment will also impact the Group's returns on its substantial cash holdings.

Because of the unpredictable nature of the frequency, size and timing of losses, including payments, that may arise under the Group's insurance policies, the Group's liquidity needs could be substantial from time to time. Illiquidity of certain investments may prevent the Group from selling assets in a timely manner. This may force the Group to liquidate its investments at times and prices that are not optimal. This could have a material adverse effect on the performance of its investment portfolio and therefore a material adverse effect on the Group's business, results of operations and financial position.

The Group is also considering future changes to the nature and type of investment portfolio it holds with the aim of increased diversification, through changes in the mix of asset type held, duration and currency of denomination, which could result in future investment returns, including future investment gains, being lower and/or more volatile.

In particular, the Group is considering investing a portion of its assets in instruments denominated in US dollars. The Group currently intends to hedge most of its foreign exchange risks in the future, including any investments in US dollars. If those hedges prove ineffective, inaccurate or inappropriate, or are not entered into, the impact of fluctuation in foreign currency exchange rates could adversely affect its business, results of operations and financial position.

The Group also intends to increase its investments in real estate (where it currently has a small exposure in the United Kingdom), which can be subject to higher volatility as it can be impacted by a range of factors generally outside of the Group's control, such as economic conditions.

Although not currently planned, the Group may in the future invest a portion of its assets in equities, where it currently has no exposure. Equity investments are generally subject to higher return volatility than fixed income securities, but they are also subject to fluctuations in equity prices, which may be adversely affected by economic conditions, stock market conditions and many other factors beyond the Group's control.

The Group currently holds a portion of its investments in instruments denominated in euros with the aim to provide a hedge against potential liabilities denominated in euros arising in its German and Italian businesses. In addition, the Group may in the future increase its investments in instruments denominated in euros as part of its general investment strategy, though as with US dollar denominated investments, the Group would seek to hedge most of its foreign exchange risk back to the denomination of the underlying liabilities.

As with its fixed income investments, any hedging, equity or property investments held by the Group would be classified as financial assets at fair value. In the event of future currency fluctuation or equity or property market declines, there can be no assurance as to the amount or timing of future realised losses or unrealised losses or impairments of the Group's investments, which may, in each case, adversely affect its business, results of operations and financial position.

Catastrophes, including natural disasters, may cause the Group to incur substantial losses

The Group is predominantly a personal lines insurer and, like all general insurance companies, it is subject to losses from unpredictable events that may affect multiple covered risks. In the United Kingdom, Italy and Germany, such events include both natural and man-made events, such as, but not limited to, windstorms, coastal inundation, floods, severe hail, severe winter weather, severe prolonged dry weather, other weather-related events, pandemics, large-scale fires, industrial explosions and other man-made disasters such as civil unrest and terrorist attacks.

The extent of the Group's losses from such catastrophic events is a function of their frequency, the severity of each individual event and the reinsurance arrangements the Group has in place. Some catastrophes, such as explosions, occur in small geographic areas, while others, including windstorms and floods, may produce significant damage to large, heavily populated and/or widespread areas. The Group generally seeks to reduce its exposure to such events by utilising selective underwriting and pricing practices, purchasing appropriate reinsurance, managing reinsurer concentration risk, and participating in relevant government-sponsored schemes such as Pool Re, which offers reinsurance coverage for claims arising from terrorist attacks. However, its efforts to reduce its exposure, or appropriately price, or set appropriate underwriting terms for, its exposure may not be successful. In addition, government or industry schemes, such as those relating to flood control, are subject to change which could result in pricing risk if the Group is unable to price its products appropriately or result in reputational risk if the Group is suddenly forced to change its pricing or policy coverage. The frequency and severity of catastrophes are inherently unpredictable and subject to long term external influences, such as climate change, and a single catastrophe or multiple catastrophes in any period could have a material adverse effect on the Group's business, results of operations and financial position.

The Group's business is concentrated in the United Kingdom

In the year ended 31 December 2011, the Group generated 92% of its total income in the United Kingdom. The Group is therefore particularly exposed to the economic, market, fiscal, regulatory, legislative, political and social conditions in the United Kingdom. In addition, the Group is exposed to the incidence and severity of catastrophic events in the United Kingdom, whether natural or man-made.

The Group's investment portfolio is particularly exposed to changes in UK economic and market conditions, especially in relation to its exposure to sovereign debt and UK financial services-related debt. Economic conditions have been difficult and volatile in the United Kingdom since 2008, and any further deterioration in these conditions or a long-term persistence of these conditions could result in a downturn in new business and sales volumes of the Group's products, an increase in claims, and a decrease of its investment return, which, in turn, could have a material adverse effect on the Group's business, results of operations and financial position.

Difficult conditions in the global, European or UK economy may have a material adverse effect on the Group's business, results and financial condition

The Group's results are affected by conditions in the global economy, in the United Kingdom, Europe, the US and elsewhere around the world. Since the start of the global financial crisis in 2008, the global economy has been experiencing a period of significant turbulence. The outlook for the global economy over the near to medium term remains challenging and many forecasts predict only stagnant or modest levels of GDP growth across the Group's markets (the United Kingdom, Italy and Germany) over that period.

The Group cannot predict the level of growth in the global economy, but it believes an ongoing sustained period of weak growth would have an adverse effect on its business and results of operations. In addition, the fixed-income markets have experienced an extended period of volatility (increasing in the second half of 2011) which has negatively impacted market liquidity conditions. Continuing market volatility may have an adverse effect on the Group, in part because it has a large investment portfolio and is also dependent upon customer behaviour. Even in the absence of a downturn in the global economy, the Group is exposed to risk of loss due to the impact of market volatility on its investment portfolio.

Factors such as inflation, consumer spending, business investment, government spending and the volatility and strength of both debt and equity markets all affect the business and economic environment and, ultimately, the amount and profitability of the Group's business. In the current economic downturn, characterised by higher unemployment, lower household income, lower corporate earnings, lower business investment, and lower consumer spending, the demand for the Group's insurance products has been and could continue to be adversely affected. In addition, the Group may experience an elevated incidence or cost of claims, including higher claims inflation or fraudulent claims, as well as changes in accident rates, any of which could affect the current and future profitability of its business. A prolonged economic downturn could result in lower sales figures in the future as consumers may choose to reduce their insurance cover or purchases, defer buying or stop buying insurance altogether. These adverse changes in the economy could affect earnings negatively and could have a material adverse effect on the Group's business, results of operations and financial position.

Although a number of economies in Europe and elsewhere experienced a degree of recovery in 2010 and the first half of 2011, volatility increased in the second half of 2011 as a result of the continuing uncertainty regarding the ability of certain Member States, including Greece, Spain, Portugal, Italy and Ireland, to service their sovereign debt obligations, the stability of numerous European banks and the downgrade of US sovereign debt by ratings providers within the Standard & Poor's group in August 2011. This elevated risk of sovereign default by certain Member States and the heightened concerns regarding the contagion effect such a default would have on other EU economies has contributed to increased uncertainty regarding the future of the eurozone and the ongoing viability of the euro currency. The long-term ratings of a majority of eurozone countries have recently been downgraded and further downgrades may occur. Economic growth in the eurozone as a whole is predicted to be negative in 2012 (Source: Consensus Economics Inc, Eurostat, ONS).

A breakup of the eurozone could have a significant impact on the Group's business, both from an investment and an operational perspective, although the nature and extent of any potential impact is unknown and very difficult to estimate, and would be dependent, in part, on the cause, timing and extent of any such break up. A eurozone break-up could result in heightened counterparty risk as well as adversely affect the management of market risk and in particular asset and liability management due, in part, to redenomination of financial assets and liabilities. Should the scope and severity of the adverse economic conditions currently experienced by some Member States and elsewhere worsen, the risks faced by the Group would be exacerbated. Developments relating to the current economic conditions and unfavourable financial environment, including those discussed above, could have a material adverse effect on the Group's business, results of operations and financial position.

A sustained period of low interest rates or interest rate volatility could adversely affect claims settlements

The current economic environment could give rise to a sustained period of low interest rates or increased interest rate volatility, which could impact claims settlements and, as a result, the financial performance and overall capital position of the Group. Since the Ogden discount rate is used to calculate the present value of future costs or lost earnings in the cases of bodily injury or death, periods of sustained low interest rates or increased interest rate volatility could result in pressure from claimants to reduce the Ogden discount rate to compensate for lower or uncertain expected returns, thereby increasing the present value of those future costs and the value of lump sum payments owed to settle claims. Fear of low or volatile returns on claims settlements caused by low or volatile interest rates could also encourage more claimants to pursue PPO awards for bodily injury claims instead of lump sum awards. A decrease in the Ogden discount rate or an increase in the propensity of PPO claims could increase the likelihood of a mismatch between the assumptions underlying the pricing of the Group's products and the actual claims and expenses experience. Further, if the current economic environment worsens, the Group would not only experience retrospective changes to its reserves, it may not be able to recover such future higher claims costs through higher prices, which could ultimately have a negative impact on the Group's current and future financial performance and, hence, potential capital requirements and/or held capital. Any such changes could adversely affect the Group's business, results of operations and financial position.

Reinsurance may not be available, affordable or adequate to protect the Group against losses, and reinsurers may default on their reinsurance obligations

As part of its overall risk mitigation and capital management strategy, the Group purchases reinsurance to cover certain risks to which it is exposed, such as the risk of single or multiple weather related catastrophes through its home and commercial property businesses, businesses interruption in its commercial business, or single large vehicle related incidents through its motor business. The Group's purchase of reinsurance reflects the insurance industry practice of reinsuring a portion of the risks it underwrites. Market conditions beyond the Group's control determine the availability and cost of appropriate reinsurance and the receipt of future reinsurance recoveries. Like insurance, reinsurance has been and may continue to be cyclical and exposed to substantial market losses, which may adversely affect reinsurance pricing and availability, or its terms and conditions. Similarly, risk appetite among reinsurers may change, resulting in changes in price or willingness to reinsure certain risks in the future. Future changes in risk appetite and pricing by reinsurers may be particularly acute within motor reinsurance, where the increased propensity for awarding of PPOs to settle bodily injury claims has already led to changes in the price and availability of reinsurance. Changes to reinsurance such as removing unlimited bodily injury cover would result in a mismatch between the legal requirements of the Road Traffic Act and reinsurance cover, exposing the Group to increased retained risk. The Group may, therefore, choose not to purchase some or any reinsurance, may not be able to obtain sufficient reinsurance on acceptable terms including, but not limited to price, or at all, may purchase reinsurance which does not appropriately cover the risks it is facing, or may not be able to recover against historical reinsurance arrangements. Any of these occurrences could result in the Group holding insufficient reinsurance to cover its losses, both in terms of its technical reserves and in terms of future business, which would materially adversely affect its ability to underwrite future business and/or expose it to higher levels of losses. Further, changes in the reinsurance protection afforded to the Group, whether by choice or through market or other external circumstances, may adversely impact the Group's capital requirement due to the reduced protection available as a result.

The Group purchases reinsurance under various agreements that cover defined blocks of business generally on a yearly renewable, per risk excess of loss or catastrophe excess of loss basis. These reinsurance agreements are designed to transfer risk and minimise the effect of losses. The amount of any particular risk that the Group decides to retain depends on an evaluation of the specific risk, and is therefore subject to uncertainty through the need to estimate likely future impact and, in certain circumstances, is subject to maximum limits based on the characteristics of coverage. Under the terms of these reinsurance agreements and in return for the premium paid, the reinsurer agrees to reimburse the Group for a portion of the claim paid to a policyholder and/or third party claimant, or a portion of claims paid to a number of policyholders in the case of a catastrophic event. However, the insurance subsidiaries within the Group remain liable to their policyholders if any reinsurer fails to meet its reinsurance obligations, whether due to the reinsurer experiencing financial difficulties, a dispute over policy coverage between the Group and the reinsurer, or otherwise. A default by a reinsurer to which the Group has material exposure could expose the Group to significant and unexpected losses and therefore have a material adverse effect on its business, results of operations and financial position.

In particular, the Group has material long term exposure to reinsurers in relation to its PPO claims provisions, where recoveries due from reinsurers in relation to such claims are estimated to occur significantly into the future, which increases the credit risk associated with such recoveries.

The Group's largest reinsurance providers are currently Swiss Re, Munich Re and General Re, which together underwrite a substantial portion of the Group's overall reinsurance programmes. Changes to the policies or pricing of these or any other reinsurers could have a significant impact on the Group's business.

The Group is exposed to counterparty risk, particularly in relation to other financial institutions including reinsurers

The Group is exposed to counterparty risk in relation to third parties in a number of ways, including but not limited to, holdings of fixed income instruments in its investment portfolios, its cash holdings, through reinsurance counterparties and through policyholders.

Counterparty risk may arise in investments as a consequence of changes in market value. The Group's business could also suffer significant losses due to defaults on fixed income investments, or the Group's reinsurers or other counterparties could fail to honour their obligations. Any losses from counterparties' failure to honour obligations and payments could have a material adverse effect on the Group's business, results of operations and financial position.

In the global financial system, financial institutions are interdependent, including with respect to reinsurers. The interdependence of financial institutions means that the failure of a sufficiently large and influential financial institution or other major counterparty (for example, a sovereign issuer), for whatever reason, could materially disrupt markets and could lead to a chain of defaults by counterparties. This risk, known as "systemic risk", could adversely impact the Group in many ways, some of which may be unpredictable, and may also adversely impact future sales as a result of reduced confidence in the insurance industry or reduced ability or willingness to buy cover on the part of customers, and adversely affect the Group's ability to recover from its reinsurance policies. The Group believes that, despite increased focus by regulators with respect to systemic risk, this risk remains part of the financial system and dislocations caused by the interdependence of financial market participants could adversely affect its business, results of operations and financial position.

The insurance business has historically been cyclical, experiencing periods of excess underwriting capacity and unfavourable premium rates and policy terms, and such cycles may occur again

Insurers have historically experienced significant fluctuations in operating results due to competition, the frequency or severity of catastrophic events, the levels of underwriting capacity, general social, legal or economic conditions and other factors. The supply of insurance capacity is related to prevailing prices, the level of insured losses and the level of industry profitability and capital surplus which, in turn, may fluctuate in response to changes in inflation rates, the rates of return on investments being earned by the insurance industry, as well as other social, economic, legal and political changes. As a result, the insurance business has historically been cyclical, characterized by periods of intense competition in relation to price and policy terms and conditions often due to excessive underwriting capacity, as well as periods when shortages of capacity have seen increased premium rates and policy terms and conditions that are more advantageous to underwriters. Increases in the supply of insurance (and, similarly, reduction in consumer demand for insurance) could have adverse consequences for the Group, including fewer contracts written, lower premium rates, increased expenses for customer acquisition and retention, and less favourable policy terms and conditions for the Group, any of which could adversely affect its business, results of operations and financial position.

The Group is required to maintain significant levels of capital and to comply with a number of regulatory requirements relating to its operations, solvency and reporting bases

The Group and its insurance and other regulated subsidiaries are required to maintain a significant margin of solvency in excess of the value of their liabilities to comply with a number of regulatory requirements relating to the Group's and such subsidiaries' solvency and reporting bases. These regulatory requirements apply to individual insurance subsidiaries on a standalone basis and in respect of the Group as a whole. The amount of regulatory and economic capital required also depends on the level of risk facing the insurance and other subsidiaries in the Group, and as such correlates to economic and general insurance market cycles. As at 31 December 2011, on an Insurance Groups Directive basis, the Group's Insurance Groups Directive ("**IGD"**) coverage ratio was 319%, although this ratio will be impacted by the Group's intended capital actions, see "*The Issuer and the Group—Description of the Business of the Issuer and the Group—Capital Resources—Capital management actions*". However, the regulatory regime governing capital and solvency is currently in the process of changing, see "*—The European Union is currently in the process of introducing a new regime governing solvency requirements, technical reserves, and other requirements for insurance companies, the effect of which is uncertain*".

The Group's capital position can be adversely impacted by a number of factors, in particular, factors which erode the Group's capital resources, which could impact the quantum of risk to which the Group is exposed. As such, any event which erodes current profitability and is expected to reduce future profitability and/or make profitability more volatile could impact the Group's capital position, which in turn could have a compounding or pro-cyclical negative affect on the Group's results of operations. In certain cases, the Group could also be required to contribute a portion of its capital to the RBS Group.

The Board is responsible for managing the capital position of the Group. In the event that regulatory capital requirements are, or may be, breached, the supervisory authorities are likely to require the Group or any of its regulated subsidiaries to take remedial action, which could possibly include measures to restore the Group's or the individual subsidiary's capital and solvency positions to levels acceptable to such authorities, to help ensure that the financial resources necessary to meet obligations to policyholders are maintained. In addition, for a variety of reasons including the recent economic downturn, the risk profile of peer companies of the Group and the industry as a whole, and the specific current or potential future risk profile of the Group's individual businesses as well as the strategic initiatives that have recently been taken or identified by the Group (or which are taken or identified in the future), either the Board or the supervisory authorities could decide to increase the regulatory capital requirements of any of the Group's regulated subsidiaries, and the Group overall.

If the Group is unable to meet its regulatory capital requirements by redeploying existing available capital, it would have to take other measures to protect its capital and solvency position. These measures might include increasing prices, reducing the volume of or types of business underwritten or divesting parts of its business, any of which may be difficult or costly or result in a significant loss, particularly in cases where such measures are required to be undertaken quickly.

The Group might also have to raise additional capital in the form of debt or equity to meet regulatory capital requirements. Raising additional capital from external sources might be possible only on unfavourable terms or not at all, due to factors outside the Group's control, such as market conditions. In addition, the Group and its regulated subsidiaries might have to reduce the amount of dividends they pay to their respective shareholders, or possibly cease paying any dividends to meet their regulatory capital requirements.

If the regulatory capital requirements are not met (because the Group could not take appropriate measures or because the measures were not sufficiently effective), the Group could lose any of its licences and hence be forced to cease some or all of its insurance and/or business operations. In such circumstances, the Guarantor and therefore the Issuer will not be allowed to pay dividends and pressure is likely to be applied in relation to intragroup arrangements and other regulated subsidiaries. Any of these measures could have a material adverse effect on the Group's business, results of operations and financial position.

The Group is subject to extensive regulatory supervision, including requirements to maintain certain licenses, permissions and/or authorisations, both in the United Kingdom and internationally

The Group's insurance subsidiaries in the United Kingdom, Germany and Italy are subject to detailed and comprehensive government regulation and legislation (see generally "*Regulatory Overview*"). Regulatory agencies have broad powers over many aspects of the insurance business, which may include marketing and selling practices, advertising, licensing agents, product development and structures, premium rates, policy forms, claims and complaint handling practices, data and records management, systems and controls, capital requirements and adequacy, and permitted investments. For example, in the United Kingdom the FSA has the power to make enquiries of the companies it regulates regarding their compliance with regulations governing the operation of businesses, and the Group faces the risk that the FSA might find that it has failed to comply with applicable regulations or has not undertaken corrective action where required. Government regulators are concerned primarily with financial stability and the protection of policyholders and third party claimants rather than the Group's shareholders or creditors, and have been giving increasing attention to consumer issues and the overall fairness of insurance products. Insurance and non-insurance laws, regulations and policies currently affecting the Group, and the approach and attitude of insurance regulators may change at any time in ways which have an adverse effect on the Group's business.

In order to conduct business in the jurisdictions in which the Group currently operates, it must obtain and maintain certain licenses, permissions and authorisations (such as, permission from the FSA to conduct insurance activities in the United Kingdom under Part IV of the FSMA) and must comply with rules and regulations as determined by these jurisdictions. Failure to comply with the promulgated regulations, applicable insurance laws and public approvals and policies may lead to legal or regulatory disciplinary action, the imposition of fines or the revocation of licenses, permissions or authorisations, which could have a material adverse impact on the Group's continued conduct of business in that jurisdiction.

In addition to consumer protection measures imposed on the Group by financial services regulators, the Group is also subject to consumer protection laws enforced by the Office of Fair Trading ("**OFT**"), the UK Competition Commission and the European Competition Commission, such as laws relating to consumer credit as well as price fixing, collusion and other anti-competitive behaviour in the United Kingdom. For example, the OFT recently launched a market study into private motor insurance focused on credit vehicle hire companies and vehicle repairs. The OFT has yet to complete this study and the Board cannot estimate with any certainty either the timing for this review or the effect it may have on the Group. See "*Regulatory Overview—Regulatory developments*" for further information.

In addition, the Group, like many other financial institutions, has come under greater regulatory scrutiny in recent years and expects that environment to continue for the foreseeable future, particularly as it relates to compliance with new and existing corporate governance, employee compensation, conduct of business, product governance, anti-money laundering, anti-terrorism and sanctions laws and regulations, as well as the provisions of applicable sanctions requirements (see "*Regulatory Overview—Anti-money laundering, anti-terrorism and sanctions laws and regulations*"). Regulatory investigations and/or enforcement actions against the Group in relation to anti-money laundering, anti-terrorism and sanctions laws or regulations could result in fines, other sanctions, including payments with respect to liabilities relating to historical business, and immediate reputational and regulatory risks, and materially adversely impact its business, results of operations and financial position.

Changes in both the regulatory requirements that apply to the Group, such as prudential rules on capital adequacy frameworks or conduct rules and their application, and the approach and/or architecture of national and/or EU financial services regulators (particularly a principles-based approach to compliance), may result in an increased number of regulatory investigations and actions. Further, the insurance and wider financial services industries face a number of regulatory initiatives aimed at addressing lessons learned from the financial crisis and other industry-level issues such as payment protection insurance mis-selling (see "*Regulatory Overview—Regulatory developments*"). In addition, new UK regulatory bodies are in the process of being established and the proposals on how they will operate are still to be approved by the UK Parliament (see "*—Changes in laws, regulations, government policies and their enforcement and interpretations could adversely affect the Group*"). It is likely that the changes will impact how the Group will interact with its financial services regulators going forward. While the Group will seek to ensure that it is prepared for this new system of regulation, there are additional risks associated with the uncertainty over how the new financial services regulators intend to apply their new powers and whether the new system will result in more intrusive and intensive regulation or supervision, adding additional burdens on the Group's resources and further compliance risk. Any change in regulatory focus in the United Kingdom or European Union on product regulation may also impact the Group's ability to sell certain products in the future, which may adversely affect the Group and its partnership arrangements. The Group could be impacted by these regulatory changes as well as other global initiatives, European initiatives and national initiatives in the markets within which it operates.

The Group's businesses in Italy and Germany are regulated by local regulators that have broadly similar powers to those in the United Kingdom, and could therefore have a similar negative impact on the Group's reputation or business. Regulatory action, whether arising from EU, UK or other local laws and regulations, against a member of the Group or a determination that the Group has failed to comply with applicable regulation, including, without limitation, any of the examples discussed herein, could result in fines and losses as well as adverse publicity for, or negative perceptions regarding, the Group, which in turn could have an adverse effect on the Group's business, results of operations and financial position, or otherwise divert management's attention from the day-to-day management of the business, potentially impacting its ongoing or future performance.

Changes in laws, regulations, government policies and their enforcement and interpretations could adversely affect the Group

The Group will not always be able to predict accurately the impact on the Group's business, results of operations and financial position of future legislation or regulation or changes in the enforcement, interpretation or operation of existing legislation or regulation. Changes in government policy, legislation or regulatory interpretation or enforcement (at a national and/or EU level) applying to companies in the financial services and insurance industries in any of the markets in which the Group operates may be applied retrospectively, and may adversely affect the Group's underlying profitability, its product range, distribution channels, capital requirements and, consequently, results and financing requirements. Examples of recent or future legislation or regulation include the reorganisation of the FSA into two successor bodies, the Prudential Regulation Authority and the Financial Conduct Authority, the implementation of gender-neutral pricing at the end of 2012, the impact of historical and future changes in the Financial Services Compensation Scheme in the United Kingdom, including the risk of failure in other financial services sectors impacting the levies on insurers, changes by the UK Motor Insurers' Bureau with respect to vehicles declared "off the road", the proposed banning of legal referral fees, proposed amendments to UK insurance contract law and new EU solvency requirements. Legislation and regulation recently proposed in the United Kingdom such as the introduction of the Legal Aid, Sentencing and Punishment of Offenders Bill 2010/11 and other reforms to costs in the English civil litigation system proposed by Lord Justice Jackson, amendments to discount rates and application of PPOs, have the propensity to increase as well as reduce the Group's income and costs. The financial consequences of any such change cannot be estimated before further detail becomes available. In addition, new powers will be introduced allowing the Financial Conduct Authority to intervene to ban products, which could impact the Group's ability to sell certain products and/or reduce their expected profitability, or may involve significant liabilities in relation to historical business underwritten by the Group and/or the industry as a whole. At the EU level, the European Parliament recently created the European Insurance and Occupational Pensions Authority, which will have extended powers to develop the detailed aspects of the Solvency II regime (see "*—The European Union is currently in the process of introducing a new regime governing solvency requirements, technical reserves, and other requirements for insurance companies, the effect of which is uncertain*"), regulate marketing activities and provide guidelines and recommendations to national supervisors, including those in the United Kingdom. The new regulatory bodies in the United Kingdom and European Union are still in the process of being established, and it remains unclear how any of them will apply their powers or how the application of their powers may impact the Group. For further information, see "*Regulatory Overview—Regulatory developments*".

The Group's technical reserves are exposed to retrospective and prospective legal changes through court awards and other changes, such as the impact of a potential change in the Ogden discount rate used to calculate lump sum awards, allowance of a new head of claim or type of claim, and other inflationary trends. In addition, changes in the enforcement of laws, regulations or government policies as a result of political developments, worsening economic conditions or, in certain cases, introduction of government austerity measures, or otherwise, could result in an increase in the frequency or quantum of fines or other adverse government intervention, and, in turn, reputational and other adverse impacts to the Group's business. The Group may also face increased compliance costs due to such changes to financial services legislation or regulation, or due to the need to set up additional compliance controls. Any such changes could have a material adverse effect on the Group's business, results of operations and financial position.

The European Union is currently in the process of introducing a new regime governing solvency requirements, technical reserves, and other requirements for insurance companies, the effect of which is uncertain

The European Union is in the process of developing and implementing a new regime in relation to solvency requirements and other matters, affecting the financial strength of insurers and reinsurers ("**Solvency II**") within each Member State. It is intended that the new regime for insurers and reinsurers domiciled in the European Union will apply more risk sensitive standards to capital requirements, bringing European insurance regulation more closely in line with banking and security regulation with a view to avoiding regulatory arbitrage, aligning regulatory capital with economic capital, and enhancing public disclosure and transparency. As a result, the general treatment of capital is likely to change, and the Group's existing and future capital resources may not meet Solvency II requirements in either form or amount.

In addition to new capital requirements and procedures, the Solvency II regime is also expected to require changes to business operations, including the organisation of, input to, and output from internal processes, the roles and responsibilities among certain key officers, and external reporting obligations, both to the regulator and the public. The significant changes to the presentation of financial information for insurers on a Solvency II basis also poses increased risk of misinterpretation by the market, third parties, stakeholders and consumers. While the overall intentions and process for implementing Solvency II are known, the future landscape of EU solvency regulation is still evolving, and the precise interpretation of the rules is still being developed. See "*Regulatory Overview—Regulatory developments—The new EU solvency regime for insurance companies*".

The European Parliament and Council of the European Union approved the directive containing the framework principles of Solvency II on 22 April and 10 November 2009, respectively. At present, it is expected that each Member State will be required to implement the new rules by 1 January 2013, with the regime becoming binding on insurers and reinsurers within each Member State from 1 January 2014, although uncertainty still remains as to whether these timelines will be achieved.

The Group intends to use an internal model, which it designed specifically for use with its business, to determine its regulatory capital requirement under Solvency II in relation to U K Insurance, its main UK regulated general insurance entity (which, following the Group's reorganisation of its UK regulated general insurance subsidiaries in 2011 underwrites a substantial majority of the Group's UK general insurance business). The Group's intention is that the internal model for U K Insurance will cover all risks except potentially operational risk, where it may use the standard formula prescribed by Solvency II for regulatory capital. The Group's intention is to use the standard formula for its other regulated insurance entities, potentially using "undertaking specific parameters" as part of that formula.

While the Group has been using its own methodology to calculate regulatory capital for a number of years in relation to its UK entities, this methodology is being reviewed and adjusted by the Group for U K Insurance to ensure it will be compliant with Solvency II requirements. This includes implementation of new processes to calculate technical reserves and the Group's resultant balance sheet under Solvency II requirements.

The ability of the Group to use an internal model for the purposes of calculating the capital requirement applicable at the level of U K Insurance, which will impact the Group's overall capital requirement, is subject to supervisory approval of the internal model in advance of the implementation of Solvency II. The nature and approach to such approval is extensive and complex, and significant elements of the underlying implementing measures and regulatory guidance associated with the new regulation are still uncertain. Given the nature and scope of changes required to the Group's internal systems and processes as a result of Solvency II, there is a risk that approval of the internal model for U K Insurance could be delayed or denied.

The Group intends to use the standard formula to assess and determine the regulatory capital requirements for its life insurance business and its insurance operations in Germany and Italy. This will similarly pose risks to those entities from both capital requirements and business operations perspectives. Further, the Group's Italian and German entities may also apply to use "undertaking specific parameters" as part of the standard formula. These parameters would generally serve to reduce the capital requirements under the standard formula. If the relevant Italian or German regulators (*Instituto per la Vigilanza sulle Assicurazioni Private di Interesse Collettivo* ("**ISVAP**") and *Bundesanstalt für Finanzdienstleistungsaufsicht* ("**BaFin**"), respectively) deny the use of these parameters, the capital requirement for these entities may be higher than anticipated.

Failure of U K Insurance to achieve internal model approval or the Group's Italian and German entities to use "undertaking specific parameters" to reduce their capital requirements under the standard formula could, in turn, have an adverse affect on the amount of capital resources that the Group and/or its insurance subsidiaries would be required to maintain from the date of implementation of Solvency II.

Given the uncertainty surrounding the requirements of Solvency II, including the date of its implementation, there can be no assurance that the Group will not need to strengthen its solvency capital position or modify its business operations and processes if and when Solvency II enters into force, even if the Group receives approval of its internal model. There are also risks that the Group's regulated entities may not make such changes in an appropriate and timely manner, which may result in wider regulatory action or censure over and above action relating to model approval and capital requirements including, but not limited to, capital add-ons for one or more of the Group's regulated entities. Any such imposition, including the failure to achieve internal model approval for U K Insurance, could result in negative publicity for the Group and/or its insurance subsidiaries and other adverse impacts to the Group's business, such as reduced sales volumes, contractual difficulties and a downgrade in the credit rating of U K Insurance.

To the extent that the regulatory capital requirement under Solvency II is higher than that required currently, there is a risk that the Group may need to raise additional capital, resulting in further exposure to the risks relating to capital requirements described in "*—The Group is required to maintain significant levels of capital and to comply with a number of regulatory requirements relating to its operations, solvency and* *reporting bases*", which could have a material adverse effect on the Group's business, results of operations and financial position.

Litigation and regulatory investigations and sanctions may have a material adverse effect on the Group

The Group faces significant risk of litigation and regulatory investigations and actions in the conduct of its business, including by the FSA, the OFT, Financial Ombudsman Service cases and commercial disputes with counterparties. In recent years, the financial services industry and financial products have increasingly been the subject of litigation, investigation and regulatory activity by various governmental, supervisory and enforcement authorities. For example, the FSA recently imposed a £2.17 million fine on the Group in relation to complaint file alterations. Such litigation and investigations have involved common industry practices such as the disclosure of contingent commissions, referral fees, and the sale and ongoing handling of payment protection insurance policies, resulting in significant fines and/or other costly sanctions.

The Group cannot predict the effect that the current trend towards increased litigation and investigation will have on its business or the broader insurance or financial services industries. Current and future investigations by supervisory authorities could result in sanctions, require the Group to take costly measures or result in changes in laws and regulations in a manner that is adverse to the Group and its business. Changes to the pricing or structure of any products resulting from legal or regulatory action, a substantial legal liability or a significant regulatory action could have a material adverse effect on the Group's business, results of operations and financial position. In addition, the Group's reputation could suffer, it could be fined or prohibited from engaging in its business activities or be sued by customers or other third parties if it does not comply with applicable laws, regulations or contractual obligations. It is inherently difficult to predict the outcome of many of the pending or potential future claims, regulatory proceedings and other adversarial proceedings involving the Group.

Inconsistent application of directives by regulators in different Member States may place the Group's business at a competitive disadvantage

Insurance regulation in the United Kingdom is largely based on the requirements of EU directives. Inconsistent application of directives (including Solvency II) by regulators in different Member States may place the Group's business at a competitive disadvantage to other European financial services groups. In addition, changes in the local regulatory regimes of Member States in which the Group operates could affect the calculation of the Group's solvency position and other matters.

While the aims of Solvency II are to introduce a harmonised, risk-based approach to solvency capital, there is a risk of differences in interpretation and a failure by financial services regulators to align Solvency II approaches across Europe, resulting in an unequal competitive landscape, with potentially adverse effects on the Group's business, results of operations and financial position.

The Group is exposed to particular risks specific to motor insurance

Motor insurance is the Group's largest product line by volume of in-force policies and gross written premiums, and represents a core component of the Group's overall business going forward. UK motor insurance represented 42% of total ongoing gross written premiums during the year ended 31 December 2011. While many of the risks inherent to the sale and administration of motor insurance are similar to all general insurance business lines, and are therefore discussed in greater detail elsewhere in this section, "—*Risks relating to the Group*", there remain several risks that are more relevant or even specific to this product. Those risks include, but are not limited to:

- Increased propensity of severe bodily injury claims to settle using PPOs, which exposes the Group to further earnings-related inflation as well as additional mortality, investment income and reinsurance credit risks.
- Significant competition among motor insurers, including potential new entrants, and an increasing propensity for customers to use price comparison websites ("**PCWs**").
- Increased bodily injury or third party property damage claims, which could be caused by, among others, an increased propensity of third parties to claim, increased size or severity of claims, and increased fraud associated with staged accidents, falsified claims or other fraudulent reporting.

- Enhancements in medical knowledge and techniques as well as the increasing use of rehabilitation, resulting in increased life expectancy for (severely) injured claimants, with expensive medical and rehabilitation regimes required for longer periods.
- Increased frequency of motor accidents due to potential changes in the economy, changes in fuel prices and technological changes to vehicles and roadways and other reasons.
- The exposure of motor insurance reserves to retrospective and prospective legal changes through court awards and other changes, such as the impact of a reduction in the Ogden discount rate used to calculate lump sum awards, and other inflationary trends.
- The potential for one or more global reinsurers in the future to fail, change their risk appetite and/or alter the nature or terms of their reinsurance cover, such as removing unlimited bodily injury cover.
- Uncertainty of the outcome or impact of potential regulatory or legislative changes (including, but not limited to, the abolition of certain referral fees) as a result of either current investigations and initiatives or potential future initiatives (see "*Regulatory Overview—Regulatory developments*").

The occurrence or persistence of any of these factors could have a material adverse effect on the Group's business, results of operations and financial position.

The Group is exposed to foreign exchange rate risk

The British pound sterling is the Group's reporting and functional currency. The Group, however, does enter into insurance contracts under which the premiums receivable and substantially all losses payable are denominated in euro. To mitigate the risk of any structural mismatch on those contracts, the Group holds reserves for those contracts in euro. In addition, the Group's travel, motor and certain other insurance policies may be exposed to foreign exchange risk on claims or losses incurred outside of the United Kingdom.

When the Group incurs a liability in a foreign currency, it carries such liability on its books in the original currency. These liabilities are converted from the respective foreign currency into sterling on each balance sheet date. At the same time, assets in the same amount are generally held unhedged on the balance sheet for each currency. In general, however, there is no exact match between assets and liabilities in each currency. The unrealised losses or gains on foreign currency exchange rates run through the Group's income statement. The Group may incur foreign currency exchange gains or losses as it ultimately receives premiums or settles claims payable in foreign currencies. Furthermore, a breakup of the eurozone (partial or otherwise) could result in a mismatch in currencies between assets and liabilities for the Group's businesses, and such mismatches could be difficult to hedge. See "*—Difficult conditions in the global, European or UK economy may have a material adverse effect on the Group's business, revenues, results and financial condition*".

As discussed in relation to the Group's investment portfolio, the Group is considering further diversifying its investment portfolio to include instruments denominated in US dollars and potentially other currencies, including the euro. While the Group currently intends to hedge most of its foreign exchange risks in the future, if those hedges prove ineffective or are not entered into, the impact of fluctuations in foreign currency exchange rates could adversely affect its business, results of operations and financial position.

The Group is exposed to the risk of damage to its brands, the brands of its partners and its reputation

The Group's success and results are dependent on the strength and reputation of the Group and its brands. The Group and its brands are vulnerable to adverse market perception as it operates in an industry where integrity, customer trust and confidence are paramount. The Group relies on its principal brands, Direct Line and Churchill, but is also dependent on its other brands, such as Privilege and NIG, and its partner brands, such as RBS, NatWest, Nationwide, Sainsbury's and Prudential. The Group is exposed to the risk that litigation, employee misconduct, operational failures, the outcome of regulatory or other investigations or actions, press speculation and negative publicity, amongst others, whether or not founded, could damage its brands or reputation. Any of the Group's brands or the Group's reputation could also be harmed if products or services sold by the Group (or any of its partners or intermediaries) do not perform as expected (whether or not the expectations are founded) or customers' expectations for the product change.

Negative publicity could result, for instance, from an allegation or determination that the Group has failed to comply with regulatory or legislative requirements, from failure in business continuity or performance of the Group's information technology systems, loss of customer data or confidential information, fraudulent activities, unsatisfactory service (support) levels or insufficient transparency or disclosure of information. Further, damage to the reputation of any of the Group's non-insurance products or companies, such as Green Flag, could negatively affect the reputation of the Group's insurance brands. Similarly, damage to any of the Group's individual brands could limit the Group's ability to cross-sell those products in line with its strategy. Negative publicity adversely affecting the Group's brands or its reputation could also result from misconduct or malpractice by outsourcing partners, both in local territories or off-shore, intermediaries, business promoters or other third parties linked to the Group (such as strategic partners, distributors and suppliers). In addition, because of its relationship with the RBS Group, negative publicity about the RBS Group could have a negative effect on the Group. Further, to the extent that negative publicity or reputational damage to the Group impacts one of the Group's partners, either in terms of reputational damage or sales of its products, the Group may be liable for contractually based fines or damages payments to such parties.

Any damage to the Group's brands or reputation could cause existing customers, partners or intermediaries to withdraw their business from the Group and potential customers, partners or intermediaries to be reluctant or elect not to do business with the Group. Such damage to the Group's brands or reputation could cause disproportionate damage to the Group's business, even if the negative publicity is factually inaccurate or unfounded. Furthermore, negative publicity could result in greater regulatory scrutiny and influence market or rating agencies' perception of the Group, which could make it more difficult for the Group to maintain its credit rating. The occurrence of any of these events could have an adverse effect on the Group's business, results of operations and financial position.

The Group has a number of strategic partnerships that are material to its business

The Group has entered into various strategic partnerships that are important to the marketing, sale and distribution of its products, and sells insurance under a number of key partner brands, the most important of which include Prudential, RBS/NatWest, Nationwide and Sainsbury's. The Group's partnerships with RBS/NatWest, Nationwide and Prudential accounted for a substantial portion of gross written premiums for its home business in 2011. The Group continues to consider other strategic partnership arrangements both in the United Kingdom and in its international businesses.

The Group's partners are operationally independent of the Group. The Group's partnership contracts tend to be long term, and as a result the Group may not be able to exit potentially disadvantageous contracts in a timely manner. In addition, several of the Group's partner contracts come due for renewal in close succession, which could result in a disproportionate adverse impact to the Group's partnership business if its partners do not seek to renew on similar terms, or at all. Growth in partner business may potentially result from a reduction in customers of the Group's proprietary brands and diminish the long-term benefits of those customer relationships, particularly in its home business.

The Group's partnerships could be terminated as a result of a variety of events, including breach of contract, disagreement between the Group and its partners, a downgrade in the Group's credit rating and counterparty insolvency. The business generated through the Group's partnerships could also be adversely affected by adverse changes to the Group's reputation or the reputation of its partners or changes in the business strategy of its partners, particularly if a partner chose to exit the general insurance business altogether. Termination of, or any other material change to, the Group's relationships with its partners could adversely affect the sale of its products and its growth opportunities in the United Kingdom and elsewhere, and could therefore have an adverse effect on its business, results of operations and financial position. Termination of partner relationships can also result in disputes over the dissolution or final settlement of partnership contracts, which can potentially lead to litigation and, further, the Group could be required to fulfil its partner obligations in the event of the termination of a relationship. The partnership contracts also include various requirements on the Group, and the Group may have to pay significant fines or damages under the arrangements if it fails to fulfill these obligations. The terms and conditions of the Group's agreements with partners are also subject to change from time to time, and the Group may be unable to renew its agreements with partners on similar terms, or at all.

Regulatory and other developments can have an impact on how the Group manages these partnerships and/or their expected financial performance. Industry-wide considerations, such as the sale of payment protection insurance products and packaged bank accounts (where the Group's products may be sold as part of a suite of benefits for the holder of that account) may result in new rules and regulation on the sale of these products. The outcome of these changes could force the Group and its partners to reassess their respective responsibilities and the overall pricing and packaging advantages to their products, which could adversely affect the strategic importance of these distribution channels.

Downgrades of or the revocation of the Group's financial strength credit ratings could affect its standing in the market, result in a loss of business and reduce earnings through increased costs of borrowing

U K Insurance, the Group's principal UK general insurance underwriter and the Guarantor, has been assigned an insurer financial strength rating of "A" with a stable outlook by Standard & Poor's and "A2" with a stable outlook by Moody's, as last confirmed on 7 March 2012, and 2 March 2012, respectively. Both Standard & Poor's and Moody's have predicated their insurance financial strength ratings on completion of the planned capital management actions (see "*The Issuer and the Group—Description of the Business of the Issuer and the Group—Capital Resources—Capital management actions*"). Members of the Group may have other ratings assigned by other rating agencies in the future. The Guarantor's insurer financial strength ratings are subject to periodic review by, and may be revised downward or revoked at the sole discretion of, Standard & Poor's and Moody's. In addition, Standard & Poor's and Moody's currently link the financial strength ratings of the Guarantor to the overall rating of the RBS Group. As a consequence, Standard & Poor's has indicated that its rating for the Guarantor could be affected by future rating actions on the RBS Group by Standard & Poor's, while Moody's has indicated that its rating for the Guarantor could be negatively impacted by a substantial weakening of the RBS Group's credit profile.

Standard & Poor's and Moody's are each credit rating agencies established in the European Union and registered under Regulation (EC) No 1060/2009 and each of them is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation. The ratings assigned by the rating agencies are neither an evaluation directed towards investors in the Notes nor a recommendation to buy, sell or hold the Notes.

Any downgrade in or revocation of the Guarantor's ratings may adversely affect the Group's liquidity and the cost of raising capital or cause the Group to incur additional financial obligations. Furthermore, downgrade or revocation could have a negative impact on the Group's public reputation and competitive position in the market, especially in relation to its partnerships and commercial business where partners or customers may not be willing or permitted to place their insurance with a lower rated insurer, which could result in reduced business volumes and income. All of these could have an adverse effect on the Group's business, results of operations and financial position.

The Group faces significant competition from other insurance companies and others

The Group faces significant competition (current and future) from domestic insurers, other international insurance groups and others (in any such case whether established or new entrants to the market or start-up operations) in each of the Group's principal markets, which offer or may in the future offer the same or similar products and services as the Group. The Group operates in markets in which the most important competitive factors for general insurance products include brand recognition, the utilisation of various distribution channels, product price, the quality of customer services before and after a contract is entered into (including claims handling), product flexibility and product innovation. The entry into, or the targeting of, the markets in which the Group operates, particularly the UK, by international insurers with greater financial resources or the ability to charge lower prices could adversely affect the Group's ability to obtain new, or retain existing, customers, or its ability to adjust prices.

If the Group is unable or is perceived to be unable to compete effectively within its core markets or products, its competitive position may be adversely affected which could have a material adverse effect on its business, results of operations and financial position. In particular, competitive pressures may, among other things, compel the Group to reduce prices, which may adversely affect its operating margins and underwriting results or its market share, and thereby have an adverse effect on its business, results of operations and financial position.

The Group is exposed to further changes in the competitive landscape including increased competition from other distribution channels, in particular PCWs, the long-term implications of which are not yet fully understood

Competition for general insurance products continues to intensify through the development of alternative distribution channels, such as PCWs (for example, Comparethemarket.com and Gocompare.com). PCWs are intermediaries that present multiple insurance quotes to a given buyer, allowing the buyer to make a comparison between insurance offerings based on a single set of information provided to the PCW. In recent years, a substantial and generally increasing amount of new general insurance policies has been sold through PCWs, particularly motor insurance.

Though the long-term implications of the growth in PCWs cannot be fully predicted, the Group expects the increasing use of PCWs to result in a greater incidence of Group brands acquiring new customers from other Group brands, increasing overall acquisition costs and potentially reducing the profitability of the business written due to lower or eliminated margins. See also "*—Changes to customers' behaviour could reduce demand for the Group's products*". A greater movement of customers to PCWs and away from direct marketing channels could result in greater pricing pressure as well as a reduction in the Group's insurance market share if customers move to PCWs with whom the Group does not have arrangements or new PCWs enter the market. The growing prevalence of PCWs may reduce the number of policies written by Direct Line, since the Group currently does not market that brand through PCWs in the United Kingdom. It may also lead to a reduction in the Group's ability to cross-sell products, particularly if the Group is unable to engage directly with the customer at any point during the selling process. Furthermore, growth in the use of PCWs by consumers to purchase insurance would likely lead to lower overall premium prices on such insurance, which could negatively impact the Group's business.

Consumer behaviour and attitudes, technological changes, regulatory and legislative changes and actions and other factors also affect competition. Generally, the Group could lose market share, incur losses on some or all of its activities and experience lower growth if it is unable to offer competitive, attractive and innovative products and services that are also profitable, does not choose the right marketing approach, product offering or distribution strategy, fails to implement such strategies successfully or fails to anticipate, successfully adapt or adhere to such demands and changes. In particular, competitive pressures from PCWs and other new technologies and distribution channels may require changes to the Group's business operations, including IT systems and functionality, and the Group may not be able to effectively respond to these new developments in a timely and/or appropriate manner, which could have an adverse effect on the Group's business, results of operations and financial position. Any such increases in competition could result in increased pressure on product pricing, and commissions and other acquisition costs on a number of products, which, in turn, could harm the Group's ability to maintain or increase its market share or have an adverse effect on the Group's business, results of operations and financial position.

Changes to customers' behaviour could reduce demand for the Group's products

The Group is exposed to changes in the behaviour of its customers and the markets in which it sells its insurance products. For example, changes in lifestyle, technology, regulation, or taxation could significantly alter customers' actual or perceived need for insurance and the types of insurance sought. Changes in technology could also give rise to new types of entrants into the insurance and/or insurance sales markets, for example, pay-as-you-go motor insurance, or the development of new distribution channels requiring further adaptation of the Group's business and operations. Such changes could result in reduced demand for the Group's products and require the Group to expend significant energy, resources and expenditure to change its product offering, build new risk and pricing models, modify and/or renew its operating and IT systems and/or retrain or hire new people. Changes to customer behaviour could also result in higher customer turnover. On average, the Group incurs fewer costs and/or makes higher profit retaining existing customers than it does acquiring new customers. This is true even for customers who replace one Group product with a comparable Group product offered under another brand. As a result, higher customer turnover could lead to higher overall costs and/or lower or eliminated profit margins due to increased pricing pressure. Such changes could have an adverse effect on the Group's business, results of operations and financial position.

The Group's claims management processes may be inefficient, leading to additional claims-related expenses and adverse inflation effects upon claims

A key assumption used in the pricing of the Group's insurance products as well as the provisions for claims is the relative time and efficiency with which claims will be notified, processed and paid. Efficient and effective claims management depends, among other things, on well-trained personnel making accurate and timely decisions with respect to claims handling. Inefficiencies and inaccuracies in managing and paying claims can lead to issues such as inaccurate indemnity decisions, inappropriate claims reserving and/or payment decisions, increased fraud and inaccurate management information for reserving and pricing, resulting in additional claims costs and claims handling related expenses as well as increased risk that technical reserves and/or pricing models will be inappropriate or inaccurate. This risk is particularly acute where the time lag between claim and payment is large. If the Group's claims management processes prove to be inefficient or ineffective or it otherwise suffers from costs or expenses above expected levels, the Group could be forced to refine its pricing models, potentially resulting in a loss of business, and increase its technical reserves. Such additional costs or inflation effects could harm the Group's profitability, which could have an overall adverse effect on the Group's business, results of operations and financial position.

The Group is exposed to fraud risks

The Group is vulnerable to internal and external fraud from a variety of sources such as employees, suppliers, intermediaries, customers and other third parties. This includes both policy (i.e. application-related) fraud and claims fraud. Although the Group employs fraud detection processes to help monitor and combat fraud, the Group is at risk from customers who misrepresent or fail to provide full disclosure of the risks covered before such cover is purchased, from policyholders who file fraudulent or exaggerated claims and from a range of other fraud related exposures, such as the fraudulent use of Group-related confidential information. These risks are higher in periods of financial stress and include payment security risks.

Additionally, the Group experiences risk from employees and staff members who fail to follow or circumvent procedures designed to prevent fraudulent activities. The occurrence or persistence of fraud in any aspect of the Group's business could damage its reputation and brands as well as its financial standing, and could have a material adverse effect on the its business, results of operations and financial position.

The Group's operations support complex transactions and are highly dependent on the proper functioning of information technology and communication systems

The Group relies heavily on its operational processes and information technology and communication systems ("**IT**") to conduct its business, including the pricing and sale of its products, measuring and monitoring its underwriting liabilities, dealing with claims, assessing acceptable levels of risk exposure, setting required levels of provisions and capital, maintaining customer service and accurate records, and compliance with its reporting obligations. These processes and systems may not operate as expected, or may not fulfil their intended purpose, which may result in the Group's operations and processes and/or outcomes of such operations and processes being inefficient, ineffective and/or inaccurate and adversely affect the overall operational or financial performance of the business. In particular, certain of the Group's older systems are not operationally efficient and may cause inefficiencies or inaccuracies in, among other things, selling and claims handling.

Furthermore, in preparation for, and as a consequence of, the Group's divestment from the RBS Group, the Group is in the process of designing, and will in the future implement, new IT and communications systems and processes in order to operate on a stand alone basis, including through new arrangements with third-party suppliers. These key new IT initiatives' are complex and significant, both in terms of scale and cost. Furthermore, in connection with the migration of the IT services to the Group during and at the end of the period of the transitional services agreement with the RBS Group, the Group will be making a significant investment in its own IT to prepare for and execute that migration, and expects to incur one-off costs in the region of £100 million, before any applicable tax deduction, associated with this effort over the next two to three years. This amount, which may be capitalised in part, does not include additional operating costs to be incurred under the transitional services agreement with the RBS Group. See "*—The Group will rely on a transitional service agreement with the RBS Group, particularly with respect to IT services*". The IT initiatives may not deliver what is required on time or the IT migration may not be possible within the expected region of £100 million, or may not provide the system functionality or performance levels required to support the current and future needs of the Group's business. The terms on which the Group purchases these new IT systems and services, or the functionality of the systems themselves, may be inferior to those of the systems currently provided by the RBS Group or those available elsewhere in the market and, in relation to third-party suppliers, may be on terms that are less favourable than the terms on which services are currently provided by third parties to the RBS Group, and from which the Group benefits. See also "*—The Group may fail to execute its ongoing transformation plan and/or the expected benefits of that plan may not be achieved*".

The Group has in place business continuity procedures, including disaster recovery systems and security measures to protect against IT and related systems failure or disruption. However, those procedures and measures may not be adequate or effective to ensure that the Group is able to carry on its business in the ordinary course if its systems fail or are disrupted, and they may not enable the Group to anticipate, prevent or mitigate a material adverse effect on the Group's business, results of operations, or financial position resulting from such failure or disruption. In particular, a number of the Group's IT and other operational systems and processes (e.g. voice recording technology) are old and are no longer supported by vendors. While subject to ongoing replacement projects, these systems and processes are particularly susceptible to causing potentially significant operational disruption to the Group in the event of their failure, including due to the resultant delays which attempts to remedy them may entail.

Interruptions to the Group's IT systems and services, whether under current arrangements or the new IT systems and services to be implemented by the Group, or failure of the Group's operational systems to keep pace with its business needs could result in the Group's inability: to gather appropriate and accurate information for key business processes, such as pricing, underwriting and reserving; to attract and retain customers; to sell business, handle claims and complaints; to report accurately; to manage its employees effectively; and to otherwise manage its business effectively, efficiently, and compliantly. It could also result in material damage to the Group's brands and reputation and adversely affect the Group's ability to compete with its competitors. In such cases, the Group would likely incur higher administrative costs both from the processing of business and potential remediation of disputes. The Group could also suffer from a loss of operational capacity as a result of natural or man-made disaster, failure of its operations systems to function properly, loss of key operations personnel, or otherwise. Inefficiencies, disruptions or failures to any of its operations and controls could have a material adverse effect on the Group's business, results of operations and financial position.

The Group will rely on a transitional service agreement with the RBS Group, particularly with respect to IT services

In connection with the Group's divestment from the RBS Group, the Group expects to enter into a transitional services agreement (the "**TSA**") with the RBS Group for the continued provision of certain services for a relevant period. Services expected to be provided for under the TSA include, without limitation, certain IT, business continuity, property, and web services. In particular, the Group will rely on the RBS Group to provide IT systems and services which are critical to support the ongoing needs of the business (including relating to its partners). The TSA will also provide for the RBS Group to assist with the migration of several systems and associated data from the RBS Group infrastructure to that of the Group or third parties at or prior to the end of the TSA period. As with all of the Group's IT systems, interruptions to or problems with the Group's IT systems and services provided under the TSA or as a result of migration from the RBS Group infrastructure could cause material damage to the Group's business and reputation, and could cause the Group to incur higher administrative and other costs both for the processing of business and the potential remediation of disputes. If the RBS Group fails to provide or procure the services envisaged or provide them in a timely manner, whether prior to entry into the TSA, under the TSA or as part of the transition out of the TSA, such failure could have a material adverse effect on the Group's business, results of operations and financial position.

The Group is dependent on the use of third-party IT, software, data and service providers

Certain of the Group's IT and operational support functions are outsourced to third parties but remain critical to the Group's business, such as mitigation of electronic attacks. Some of these functions are sourced by the Group directly while others are or will be provided to the Group indirectly through relationships between third parties and the RBS Group. In addition, the Group is dependent on the use of certain third party software and data in order to conduct its business, including in pricing of products and reserving claims. Further, the outsourcing to third parties has involved the relocation of some of the Group's back office operations to third party providers based in India, and may include additional relocation of operations (both front and back office) to areas outside the United Kingdom in the future. The Group is reliant in part on the continued performance, accuracy, compliance and security of these service providers. If the contractual arrangements with any third party providers are terminated, the Group may not find an alternative outsource provider or supplier for the services, on a timely basis, on equivalent terms or at all.

In addition, the information and processes the Group uses may be protected by patents, copyrights in software or other materials, rights in databases, rights of confidence or other intellectual property rights owned by third parties. The Group seeks to obtain such licences or consents in respect of any intellectual property rights owned by third parties that it may identify as necessary to its business. However, claims that its activities infringe such third party intellectual property rights could adversely affect the Group's business.

Third party providers have also mishandled the Group's customer data on certain occasions, resulting in the Group having to make notifications of such incidents to the relevant regulators. Any reduction in third party product quality or any failure by a third party to comply with the Group's licensing or regulatory requirements, including requirements with respect to the handling of customer data, could cause a material disruption to or adverse financial and/or reputational impact on the Group's business. Any of these events could have a material adverse effect on the Group's business, results of operations and financial position.

Failure to maintain adequately and protect customer and employee information could have a material adverse effect on the Group

The Group collects and processes personal data (including name, address, age, bank and credit card details and other personal data) from its customers, third party claimants, business contacts and employees as part of the operation of its business, and therefore it must comply with data protection and privacy laws in the United Kingdom, Germany and Italy. Those laws impose certain requirements on the Group in respect of the collection, use and processing of such personal information. For example, under UK and EU data protection laws and regulations, when collecting personal data, certain information must be provided to the individual whose data is being collected. This information includes the identity of the data controller, the purpose for which the data is being collected and any other relevant information relating to the processing. There is a risk that data collected by the Group and its appointed third parties is not processed in accordance with notifications made to both data subjects and regulators. Failure to operate effective data collection controls could potentially lead to regulatory censure, fines, reputational and financial costs as well as result in potential inaccurate rating of policies or overpayment of claims.

As a result of separation from the RBS Group, the Group may need to continue to access certain customer data that resides within systems maintained by the RBS Group, and there is a risk that accessing such customer data may prove difficult or inefficient following separation because of data protection laws applicable to both the Group and the RBS Group.

In addition, the Group is exposed to the risk that the personal data it controls could be wrongfully accessed and/or used, whether by employees or other third parties, or otherwise lost or disclosed or processed in breach of data protection regulations. If the Group or any of the third party service providers on which it relies (including the RBS Group, under current arrangements or under the TSA) fail to process, store or protect such personal data in a secure manner or if any such theft or loss of personal data were otherwise to occur, the Group could face liability under data protection laws. This could also result in damage to the Group's brands and reputation as well as the loss of new or repeat business, any of which could have a material adverse effect on the Group's business, results of operations and financial position.

The Group faces a number of risks in connection with its divestment from the RBS Group

As part of its preparation for divestment from the RBS Group, the Group is in the process of establishing its own stand-alone arrangements in a wide range of areas including human resources and payroll, head office, governance, and controlled functions, where it currently relies on support and services from the RBS Group, the majority of which will not be provided under the TSA. There is a risk that the process of establishing these functions could divert management's attention from the ongoing operations of the business or otherwise require management to expend significant energy and resources to implement the divestment actions. In addition, other one-off and exceptional costs of divestment and separation from the RBS Group are significant. These costs, which include costs relating to the assumption of property leases and the Section 75 Debt (as discussed below in "*—The Group will likely crystallise a debt as a result of changes to a defined benefit pension scheme for certain employees*") but not the costs relating to migration of the Group's IT services from the RBS Group (as identified under the heading "*—The Group's operations support complex transactions and are highly dependent on the proper functioning of information technology and communication systems*") are currently estimated to be in the range of £125 million to £175 million, before any applicable tax deduction. These costs, which may be capitalised in part, are expected to be incurred during 2012. However, the actual costs could be higher and the period over which they are incurred could be longer. Furthermore, if the Group is unable to manage the separation, migration and establishment of these processes, systems and functions as part of the overall divestment, including, in due course, migration of any services provided under the TSA, it could suffer operational difficulties which could materially affect the Group's overall business, results of operations and financial position.

The Group could be adversely affected by the loss of one or more key employees, or by an inability to attract and retain, or obtain FSA approval for, qualified personnel

The Group depends on the continued contributions of its senior management and other key employees, a number of whom have only recently joined the Group. The loss of services of one or more of the Group's key employees could adversely affect its business. The Group's continued success also depends on its ability to attract, motivate and retain highly competent specialists, particularly those with financial, IT, underwriting, actuarial, Solvency II and other specialist skills. Competition for senior managers as well as personnel with these skills and proven ability is intense among insurance companies. The Group competes with other financial services groups for skilled personnel, primarily on the basis of its reputation, financial position, remuneration policies and support services, and may incur significant costs to retain qualified individuals.

In addition, the FSA also has the power to regulate individuals in the insurance business who deal with customers, such as providing advice to customers on insurance products, and individuals with significant influence over the key functions of an insurance business, such as governance, finance, audit and management functions. The FSA may not approve individuals for such functions unless it is satisfied that they have appropriate qualifications and/or experience and are fit and proper to perform those functions, and may withdraw its approval for individuals whom it deems no longer fit and proper to perform those functions.

As part of the separation from the RBS Group, approximately 700 UK employees from certain entities in the RBS Group will transfer to entities within the Group, and the Group will standardise the employment terms and benefits, including pensions, of those individuals as well as of existing Group UK employees. There is a risk that employees may not agree to the new employment terms, and may seek to negotiate different terms or, in extreme cases, disrupt the Group's business through industrial action or otherwise. Significant disruption to the Group's business caused by this process could also have a material adverse impact on its reputation, resulting in declines in performance of all the Group's employees and/or losses of employees. In addition, the Group's employees in Italy and Germany are represented through collective bargaining agreements, and there is a risk that economic uncertainties, particularly with respect to austerity measures in Italy, could lead to possible disputes with employees in those countries.

The Group's inability to attract and retain, or obtain FSA approval for, directors and highly skilled personnel, and to retain, motivate and train its staff effectively could adversely affect its competitive position, which could in turn result in an adverse effect to its business, results of operations and financial position.

The Group will likely crystallise a debt as a result of changes to a defined benefit pension scheme for certain employees

In preparation for separation from the RBS Group, the Group is in the process of standardising the employment terms of all Group employees. Changes to the employment terms of a small proportion of Group employees who are currently members of the RBS Group defined benefit pension scheme, which is expected to occur prior to divestment from the RBS Group, will result in the crystallisation of a debt under section 75 of the UK Pensions Act 1995 (the "**Section 75 Debt**") that the Group would be required to pay into the RBS Group's defined benefit pension scheme (in which such employees will cease to participate) as a result of a deficit in that scheme. The Section 75 Debt is calculated based on the amount needed to secure the Group's share of the pension liabilities in the pension scheme with an insurance company. Based on the most recent available valuation information, the Board understands that the amount of the Section 75 Debt would have been approximately £33 million before tax and £24 million after tax as at 29 February 2012. However, the actual value of the Section 75 Debt will depend on actuarial estimates and market conditions at the time of crystallisation, and may have an adverse effect on the Group's results of operations. The Group expects that the Section 75 Debt will be incurred during 2012.

The Group relies on intermediaries to market and distribute insurance, particularly within its commercial business

The Group relies on intermediaries for the marketing and distribution of a majority of its commercial products and services. The Group's intermediaries are operationally independent of the Group. In most cases, the Group does not have exclusivity agreements in place with its intermediaries, and as a result they are free to offer products from other insurance companies as well, with no obligation to give precedence to the products of the Group. The successful distribution of the Group's commercial products therefore depends on the preferences of intermediaries for the Group's products and services, and the Group competes with other insurers and financial institutions to attract and retain commercial relationships with intermediaries. In addition, some of the Group's commercial business brokers have the ability to make underwriting or claims handling decisions that could affect the Group, and may sell insurance or pay claims under circumstances otherwise outside the underwriting or claims handling policies set by the Group. Failure to maintain relationships with intermediaries or underwriting or claims handling decisions made by intermediaries in contravention of Group policies could result in a loss of market share for the Group's commercial products or a reduction in the sale or profitability of its products, which could, in turn, have an adverse effect on its business, results of operations and financial position.

The Group may make acquisitions or disposals in the future

While the Group is not currently expecting to make any acquisitions or disposals in the reasonably foreseeable future, it has in the past and may in the future make acquisitions and disposals of businesses. In any future acquisition, the Group will endeavour to conduct appropriate due diligence, which will include, amongst other matters and as appropriate, assessment of the adequacy of claims reserves, assessment of the recoverability of reinsurance and other balances, enquiries with regard to outstanding litigation and consideration of local regulatory and taxation matters where appropriate. Consideration will also be given to potential costs, risks and issues in relation to the integration of any proposed acquisitions with existing Group operations. However, there can be no assurance that the due diligence undertaken will be accurate or complete, and such due diligence may not identify or mitigate all material risks to which the entity being acquired is exposed. In addition, the integration of any proposed acquisition may not be successful or in line with the Group's expectations. The Group will seek, where appropriate, contractual representations and warranties in connection with any acquisition and, where necessary, additional indemnifications in relation to specific risks. However, there can be no guarantee that such protection will be obtained or be adequate in all circumstances. The Group may also provide relevant representations, warranties and indemnities to counterparties on any disposal. While most such clauses are likely to be customary in such contracts, they may result in the Group receiving claims from counterparties. Even if the Group identifies an attractive opportunity, it may not be able to complete successfully the acquisition or disposal based on limited financial resources or onerous regulatory requirements. Failure to adequately protect the Group from losses resulting from acquisitions or disposals, including losses resulting from the unsuccessful integration of future acquisitions, could damage the Group's reputation and brands, and could have an adverse effect on the Group's business, results of operations and financial position.

Changes in taxation laws may negatively impact the Group and/or the decisions of customers

Changes in corporate and other tax rules could have both a prospective and retrospective impact on the Group's business, results of operations or financial position. In general, changes to, or in the interpretation of, existing tax laws, or amendments to existing tax rates (corporate or personal), or the introduction of new tax legislation may adversely affect the business, results of operations and financial position of the Group, either directly or as a result of changes in the insurance purchasing decisions of customers. Changes to legislation that specifically governs the taxation of insurance companies might adversely affect the Group's business. While changes in taxation laws would affect the insurance sector as a whole, changes may be more detrimental to particular operators in the industry. The relative impact on the Group will depend on the areas impacted by the changes, the mix of business within the Group's portfolio and other relevant circumstances at the time of the change.

Changes to IFRS generally or specifically for insurance companies may adversely affect the Group's financial results

Changes to IFRS for insurance companies have been proposed in recent years and further changes may be proposed in the future. The International Accounting Standards Board has published proposals in its IFRS 4 Insurance Contracts Phase II for Insurers discussion paper that would introduce significant changes to the statutory reporting of insurance entities that prepare accounts according to IFRS. The accounting proposals will change the presentation and measurement of insurance contracts, including the effect of technical reserves and reinsurance on the value of insurance contracts. It is uncertain whether and how the proposals in the discussion paper will affect the Group should they become definitive international financial reporting standards. Current proposals under Phase II may have an adverse effect on the manner in which the Group reports provisions and therefore identifies and reports revenues and costs. These and any other changes to IFRS that may be proposed in the future, whether or not specifically targeted at insurance companies, could adversely affect the Group's results of operations and financial position.

RISKS RELATED TO OWNERSHIP BY THE RBS GROUP

The Company is currently a wholly-owned subsidiary of RBS. As a condition to receiving aid given to it by HM Treasury, the RBS Group is required to divest its controlling interest in the Company by 31 December 2013, and divest any remaining interest by 31 December 2014 (See "The Issuer and the Group—Description of the Business of the Issuer and the Group—History of the Business—Separation from the RBS Group"). *Until such time, there are risks that might impact the Company and the Group by reason of its ownership by the RBS Group. Highlighted below are certain of the key risks that apply to the RBS Group and which, should they arise, may have a material adverse impact on the Group's business, results of operations and financial position.*

The RBS Group will continue to exert substantial influence over the Group

Following the completion of the offering of the Notes, and while it remains a significant shareholder of the Group, the RBS Group will continue to have the power, among other things, to affect or influence the Group's legal and capital structure, as well as the ability to elect and change its directors, management and to approve other changes to its operations. The interests of the RBS Group could conflict with those of the Group, and this concentration of ownership may also have the effect of delaying, deferring or preventing the Group's ability to effect certain types of transactions that require approval by RBS, including by special resolution. Events within the RBS Group, including litigation involving the RBS Group or its subsidiaries, could also have a consequential effect on the Group such as a negative effect on the Group's credit rating and/or capital position. In addition, Standard & Poor's and Moody's currently link the financial strength ratings of the Guarantor to the overall rating of the RBS Group. As a consequence, Standard & Poor's has indicated that its rating for the Guarantor could be affected by future rating actions on the RBS Group by Standard & Poor's, while Moody's has indicated that its rating for the Guarantor could be negatively impacted by a substantial weakening of the RBS Group's credit profile.

The RBS Group has a legal obligation to divest its controlling interest in the Group by the end of 2013 and completely divest by the end of 2014

The RBS Group was required to obtain approval for the aid given to it by HM Treasury in December 2008 (the "**State Aid**"). As a condition to receiving State Aid, the RBS Group is required by the end of 2014 to divest its insurance business, being the Group. See also "*—The RBS Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan which could adversely affect the Group*". While the RBS Group has recently stated that the base case plan for disposal of the Group is by way of a public flotation, targeted to commence in the second half of 2012, subject to market conditions, there remains uncertainty over the timing and manner of the divestment and the identity of the eventual owners of the Group. Furthermore, the RBS Group may continue to be a majority or significant shareholder of the Group following the initial divestment. The divestment could be achieved by the listing of the Group on a stock exchange, the sale of the Group to another insurance company or financial sponsor or another owner. Should the divestment occur by way of a sale of the Group to a third party, this could subsequently result in a significant change to the strategy, management and risk profile of the Group including, subject to regulatory restrictions, the Group's capital management policy, financial leverage, investment and/or reinsurance strategy. There can be no assurance that the taking of any such actions would not adversely affect the Guarantor's credit rating, or the ability of the Group to effectively conduct its business or satisfy its obligations under the Notes or any other issued securities or related contracts. The timing of the divestment will depend, amongst other considerations, on market conditions.

In addition, a change of ownership of the Group (particularly on the sale of the Group) could result in key contracts being terminated by the counterparties to such contracts, which could give rise to material disruptions to the Group's business, additional costs to renegotiate those contracts, difficulties in managing its operations, and adverse impacts to its customers. As a result of these effects, the eventual change in ownership could have a material adverse effect on the Group's business, results of operations and financial position.

The RBS Group may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009

Under the Banking Act 2009 (the "**Banking Act**"), substantial powers have been granted to HM Treasury, the Bank of England and the FSA (together, the "**Authorities**") as part of a special resolution regime (the "**SRR**"). These powers enable the Authorities to regulate UK banks, building societies and other institutions with permission to accept deposits pursuant to Part IV of the FSMA (each a "**relevant entity**") where certain conditions are met. The SRR consists of three stabilisation options and two insolvency and administration procedures applicable to UK banks which may be commenced by the Authorities. The stabilisation options provide for: (i) transfer of all or part of the business of the relevant entity to a private sector purchaser; (ii) transfer of all or part of the business of the relevant entity to a "bridge bank" established by the Bank of England; and (iii) temporary public ownership (nationalisation) of the relevant entity or its UK-incorporated holding company. In each case, the Authorities have been granted wide powers under the Banking Act including powers to modify contractual arrangements in certain circumstances and powers for HM Treasury to disapply or modify laws (with possible retrospective effect) to enable the powers under the Banking Act to be used effectively. Nationalisation of the RBS Group could result in action being taken which is adverse to the interests of the Group and could result in material changes to the Group's business and/or impact the RBS Group's plans for divestment of the Group.

Contractual arrangements within the Group and between the RBS Group and the Group may be created, modified or cancelled depending on events that occur within the RBS Group

If the RBS Group or certain members thereof were taken into temporary public ownership and a partial transfer of its or any relevant entity's business were effected, the transfer may directly affect the Group by creating, modifying or cancelling the Group's contractual arrangements with a view to ensuring the provision of such services and facilities as are required to enable the effective operation of the transferred business (or any part of it). For example, the transfer may (among other things) (i) require the Group to support and co-operate with the transferor; (ii) cancel or modify contracts or arrangements between the transferred business and a Group company (which may include the TSA and the Group's partnership arrangements with RBS/NatWest); or (iii) impose additional obligations on the Group under new or existing contracts. There can be no assurance that the taking of any such actions would not adversely affect the ability of the Group to effectively conduct its business or satisfy its obligations under the Notes or any other issued securities or related contracts.

The RBS Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan which could adversely affect the Group

As part of the State Aid approval, the RBS Group, together with HM Treasury, agreed the terms of a restructuring plan (the "**State Aid restructuring plan**"). The RBS Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan, including required asset disposals. In particular, the RBS Group agreed to undertake a series of measures to be implemented over a four-year period from December 2009, which include disposing of the Group (subject to potentially maintaining a non-controlling interest until the end of 2014). The RBS Group has progressed with these disposals over the course of 2010, 2011, and 2012. However, if the RBS Group fails to complete any of the required disposals within the agreed timeframes for such disposals, under the terms of the State Aid approval, a divestiture trustee may be empowered to conduct the disposals, with the mandate to complete the disposal, including that of the Group at no minimum price.

Furthermore, if the RBS Group is unable to comply with the terms of the State Aid approval, it could constitute a misuse of aid. In circumstances where the European Commission doubts that the RBS Group is complying with the terms of the State Aid approval, it may open a formal investigation. At the conclusion of any such investigation, if the European Commission decided that there had been misuse of aid, it could issue a decision requiring HM Treasury to recover the misused aid which could have a material adverse impact on the RBS Group and its subsidiaries, including the Group.

In implementing the State Aid restructuring plan, the RBS Group will lose existing customers and as a result the Group will lose the potential for realising associated revenues through the sale of insurance products to those customers. The implementation of the State Aid restructuring plan may also result in disruption to the RBS Group business and give rise to significant strain on management, employee, operational and financial resources, impacting customers and the Group's associated business.

If any or all of the risks described above, or any other currently unforeseen risks, materialise, there could be a materially adverse impact on the Group's business, results of operations and financial position.

RISKS RELATED TO THE STRUCTURE OF THE NOTES

Subordination

The Issuer's payment obligations under the Notes will be unsecured and subordinated (i) on a winding-up of the Issuer and (ii) in the event that an administrator of the Issuer is appointed and gives notice that it intends to declare and distribute a dividend and, in each case, will rank junior in priority to the claims of Senior Creditors of the Issuer.

The Guarantor's payment obligations in relation to the Notes will be unsecured and subordinated (i) on a winding-up of the Guarantor and (ii) in the event that an administrator of the Guarantor is appointed and gives notice that it intends to declare and distribute a dividend and, in each case, will rank junior in priority to the claims of Senior Creditors of the Guarantor.

Although the Notes may pay a higher rate of interest than comparable notes which are not subordinated, there is a significant risk that an investor in the Notes will lose all or some of its investment should the Issuer and/or the Guarantor become insolvent.

Payments by the Issuer and the Guarantor are conditional upon the satisfaction of solvency requirements

All payments by the Issuer under or arising from the Notes are conditional upon the Issuer being solvent at the time for payment by the Issuer, and no amount shall be payable under or arising from the Notes and the Trust Deed unless and until such time as the Issuer could make such payment and still be solvent immediately thereafter (the "**Issuer Solvency Condition**"). For these purposes, the Issuer will be "solvent" if (i) it is able to pay its debts owed to Senior Creditors of the Issuer and Pari Passu Creditors of the Issuer as they fall due and (ii) its Assets exceed its Liabilities (other than Liabilities to persons who are Junior Creditors of the Issuer). If any payment of interest, Arrears of Interest and/or principal cannot be made by the Issuer in compliance with the Issuer Solvency Condition, payment of such amounts will be deferred, and such deferral will not constitute a default under the Notes for any purpose.

In addition, all payments under or arising from the Guarantee shall be conditional upon the Guarantor being solvent at the time for payment by the Guarantor, and no amount shall be payable under or arising from the Guarantee unless and until such time as the Guarantor could make such payment and still be solvent immediately thereafter (the "**Guarantor Solvency Condition**"). For these purposes, the Guarantor will be "solvent" if (i) it is able to pay its debts owed to Senior Creditors of the Guarantor and Pari Passu Creditors of the Guarantor as they fall due and (ii) its Assets exceed its Liabilities (other than Liabilities to persons who are Junior Creditors of the Guarantor). If any payment of Guaranteed Amounts in respect of interest, Arrears of Interest and/or principal cannot be made by the Guarantor in compliance with the Guarantor Solvency Condition, payment of such amounts will be deferred, and such deferral will not constitute a default under the Notes or the Guarantee for any purpose.

Interest payments under the Notes and the Guarantee may be deferred and under certain conditions must be deferred

The Issuer may, on any Optional Interest Payment Date, elect to defer payments of interest on the Notes. In addition, the Issuer is required to defer any payment of interest on the Notes (i) in the event that it cannot make such payment in compliance with the Issuer Solvency Condition or (ii) on each Mandatory Interest Deferral Date (being an Interest Payment Date in respect of which a Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment of interest was made by the Issuer on such Interest Payment Date).

The Issuer is only required to pay interest on the Notes on any Interest Payment Date (unless such date is a Mandatory Interest Deferral Date or the Issuer could not make such payment in compliance with the Issuer Solvency Condition) where, during the six months ended on such Interest Payment Date, a Compulsory Interest Payment Event has occurred, including if the Issuer has declared, paid or made a dividend or distribution to its ordinary shareholders. The Issuer has absolute discretion not to declare a dividend on its ordinary shares, and its ability to declare a dividend is dependent on a number of factors, including its financial condition and performance, the amount of its distributable profits and reserves on an unconsolidated basis, its capital requirements, applicable restrictions on the payment of dividends under applicable laws and regulations and such other factors as the Issuer's board of directors may deem relevant.

The Guarantor may, on any Guarantor Optional Interest Payment Date, elect to defer payments of Guaranteed Amounts in respect of interest on the Notes. In addition, the Guarantor is required to defer any payment of Guaranteed Amounts in respect of interest on the Notes (i) in the event that it cannot make such payment in compliance with the Guarantor Solvency Condition or (ii) on each Guarantor Mandatory Interest Deferral Date (being any date in respect of which a Guarantor Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment was made by the Guarantor on such date).

The deferral of interest (or Guaranteed Amounts in respect of interest) as described above does not constitute a default under the Notes or the Guarantee for any purpose. Any interest so deferred shall, for so long as the same remains unpaid, constitute Arrears of Interest. Arrears of Interest do not themselves bear interest. Arrears of Interest may, subject to certain conditions, be paid by the Issuer or the Guarantor at any time upon notice to Noteholders, but in any event shall be payable, subject to satisfaction of the Issuer Solvency Condition (in respect of payment by the Issuer) or the Guarantor Solvency Condition (in respect of payment by the Guarantor), (i) by the Issuer on the earliest to occur of (a) the next Interest Payment Date on which payment of interest in respect of the Notes is made, (b) an Issuer Winding-Up or (c) any redemption of the Notes pursuant to Condition 8 or Condition 11, or (ii) by the Guarantor on the earliest to occur of (a) the next date on which payment of Guaranteed Amounts in respect of interest is made, (b) a Guarantor Winding-Up or (c) redemption of the Notes by or on behalf of the Issuer pursuant to Condition 8 or Condition 11.

Any actual or anticipated deferral of interest payments will likely have an adverse effect on the market price of the Notes. In addition, as a result of the interest deferral provision of the Notes, the market price of the Notes may be more volatile than the market prices of other debt securities on which interest accrues that are not subject to such deferral and may be more sensitive generally to adverse changes in the Issuer's and the Guarantor's financial condition.

Redemption payments under the Notes must, under certain circumstances, be deferred

Notwithstanding the expected maturity of the Notes on the Maturity Date, the Issuer must defer redemption of the Notes on the Maturity Date or on any other date set for redemption of the Notes pursuant to Conditions 8.5, 8.6 and 8.7 (i) in the event that it cannot make the redemption payments in compliance with the Issuer Solvency Condition or (ii) if a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if the Notes were redeemed by the Issuer on such date.

In addition, the Guarantor must defer the payment of any Guaranteed Amounts in connection with the redemption of the Notes (i) in the event that it cannot make such payment in compliance with the Guarantor Solvency Condition or (ii) if a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if such payments were made by the Guarantor on such date.

The deferral of redemption of the Notes or the payment of Guaranteed Amounts in respect of redemption of the Notes does not constitute a default under the Notes or the Guarantee for any purpose. Where redemption of the Notes is deferred, subject to certain conditions (including satisfaction of the Issuer Solvency Condition in the case of payments by the Issuer or satisfaction of the Guarantor Solvency Condition in the case of payments by the Guarantor), (i) the Notes will be redeemed by the Issuer on the earliest of (a) the date falling 10 Business Days following cessation of the Regulatory Deficiency Redemption Deferral Event, (b) the date falling 10 Business Days after the FSA has agreed to the repayment or redemption of the Notes or (c) the date on which an Issuer Winding-Up occurs, or (ii) the Guarantor will pay Guaranteed Amounts in respect of the redemption by the Issuer of the Notes on the earliest of (a) the date falling 10 Business Days following cessation of the Guarantor Regulatory Deficiency Redemption Deferral Event, (b) the date falling 10 Business Days after the FSA has agreed to the payment of such amounts by the Guarantor or (c) the date on which a Guarantor Winding-Up occurs.

Any actual or anticipated deferral of redemption of the Notes will likely have an adverse effect on the market price of the Notes. In addition, as a result of the redemption deferral provision of the Notes, including with respect to deferring redemption on the scheduled Maturity Date, the market price of the Notes may be more volatile than the market prices of other debt securities without such deferral feature, including dated securities where redemption on the scheduled maturity date cannot be deferred, and the Notes may accordingly be more sensitive generally to adverse changes in the Issuer's and the Guarantor's financial condition.

Early Redemption

The Notes may, subject as provided in Condition 8 (*Redemption, Substitution, Variation and Purchase*), at the option of the Issuer, be redeemed before the Maturity Date at their principal amount, together with any Arrears of Interest and any other accrued but unpaid interest to (but excluding) the date of redemption, on any Interest Payment Date falling on or after the First Call Date, or prior to such date (i) in the event of certain changes in the tax treatment of the Notes or payments thereunder due to a change in applicable law or regulation or the official interpretation thereof, or (ii) following the occurrence of (or if the Issuer satisfies the Trustee that there will occur within six months) a Capital Disqualification Event or a Ratings Methodology Event (provided that, in the case of a Ratings Methodology Event, the Notes will not be redeemed prior to the fifth anniversary of the Issue Date).

A Capital Disqualification Event will occur if, as a result of any replacement of or change to (or change to the interpretation by any court or authority entitled to do so of) Solvency II or the Relevant Rules or following the implementation of Solvency II, the Notes cease to qualify in full for recognition in the capital resources of the Issuer, the Guarantor and/or the Group. As discussed in greater detail in the section of this Prospectus entitled "*Regulatory Overview*", the European Union is currently developing the Solvency II framework for insurance companies, which, amongst other things, will set out features which any instruments (including subordinated notes) must have in order to qualify as regulatory capital. These features may be different and/or more onerous than those currently applicable to insurance companies in the United Kingdom and contained in the Notes. The details of these features are not expected to be known until the publication of the final official implementation measures (Level 2) implementing Solvency II. Solvency II is expected to be formally implemented in 2013, with insurers required to comply from 2014. Accordingly, there is a risk that after the issue of the Notes, a Capital Disqualification Event may occur which would entitle the Issuer, with the consent (or non-objection) of the FSA if then required by the FSA, to redeem the Notes early at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest.

An investor may not be able to reinvest the redemption proceeds at an effective interest rate as high as the interest rate on the Notes being redeemed and may only be able to do so at a significantly lower rate. Potential investors should consider reinvestment risk in light of other investments available at that time.

Variation or substitution of the Notes without Noteholder consent

Subject as provided in Condition 8, the Issuer may, at its option and without the consent or approval of the Noteholders, elect to substitute the Notes for, or vary the terms of the Notes so that they become or remain, Qualifying Dated Tier 2 Securities or Rating Agency Compliant Securities (as the case may be) at any time in the event of certain changes in the tax treatment of the Notes or payments thereunder due to a change in applicable law or regulation or the official interpretation thereof, or following the occurrence of (or if the Issuer satisfies the Trustee that there will occur within six months) a Capital Disqualification Event or a Ratings Methodology Event.

Restricted remedy for non-payment when due

The sole remedy against each of the Issuer and the Guarantor available to the Trustee or (where the Trustee has failed to proceed against the Issuer or the Guarantor as provided in the Conditions) any Noteholder for recovery of amounts which have become due in respect of the Notes or the Guarantee will be the institution of proceedings for the winding-up in England and Wales (but not elsewhere) of the Issuer or the Guarantor and/or proving in any winding-up or in any administration of the Issuer or the Guarantor and/or claiming in the liquidation of the Issuer or the Guarantor.

Non-payment by the Issuer of any amounts when due or the occurrence of any Issuer Winding-Up will not, of itself, render the Notes immediately due and payable at their principal amount by the Guarantor, and conversely non-payment by the Guarantor of any amounts when due or the occurrence of a Guarantor Winding-Up will not, of itself, render the Notes immediately due and payable at their principal amount by the Issuer. In circumstances where the Issuer fails to make a payment when due or an Issuer Winding-Up occurs but the Guarantor does not default in its obligations, the Guarantor will continue to service the Notes (the principal amount of which may be reduced by amounts recovered in the winding-up, administration or liquidation of the Issuer in accordance with Condition 3.3) in place of the Issuer as if the Issuer default had not occurred, in accordance with Condition 4.5. Conversely, in circumstances where the Guarantor fails to make a payment when due or a Guarantor Winding-Up occurs but the Issuer does not default in its obligations, the Issuer will continue to service the Notes (the principal amount of which may be reduced by amounts recovered in the winding-up, administration or liquidation of the Guarantor in accordance with Condition 4.4) as if the Guarantor default had not occurred, in accordance with Condition 11.3(b).

Modifications and waivers

The Conditions contain provisions for calling meetings of Noteholders to consider matters affecting their interests generally. These provisions permit defined majorities to bind all Noteholders including Noteholders who did not attend and vote at the relevant meeting and Noteholders who voted in a manner contrary to the majority. The Conditions also provide that, subject to the prior consent of the FSA being obtained (so long as such consent is required), the Trustee may, without the consent of Noteholders, agree to any modification of, or to the waiver or authorisation of any breach or proposed breach of, any of the Conditions or any of the provisions of the Trust Deed in the circumstances described in Condition 15.

Substitution of obligors and transfer of business

The Conditions provide that the Trustee may, without the consent of the Noteholders, agree to the substitution of another company as principal debtor or guarantor under the Notes in place of the Issuer, or, as the case may be, the Guarantor in the circumstances described in Condition 14.

In addition, Condition 16 provides that the Guarantor may transfer the whole or a substantial part (being any part which represents 50 per cent. or more of the liabilities (where the amount of the liabilities of the Guarantor is deemed to mean the same as the technical provisions of the Guarantor, net of reinsurance) relating to policies underwritten by the Guarantor) of its business, without any prior approval from the Trustee or the Noteholders, to a successor in certain circumstances provided that all the liabilities and obligations of the Guarantor as principal obligor under the Guarantee are included in the transfer.

See also "*—The RBS Group has a legal obligation to divest its controlling interest in the Group by the end of 2013 and completely divest by the end of 2014*" relating to the requirement of RBS Group to divest its insurance business.

No limitation on issuing senior or pari passu securities

There is no restriction on the amount of securities which the Issuer or the Guarantor may issue or guarantee, which securities or guarantees rank senior to, or *pari passu* with, the Notes or the Guarantee (as applicable). The issue or guarantee of any such securities may reduce the amount recoverable by Noteholders on a winding-up of the Issuer or the Guarantor, as the case may be. In particular, the Notes shall rank junior to the claims of Senior Creditors of the Issuer, and claims of Noteholders under the Guarantee shall rank junior to the claims of Senior Creditors of the Guarantor. Accordingly, in the winding-up of the Issuer and/or the Guarantor and after payment of the claims of their respective senior ranking creditors, there may not be a sufficient amount to satisfy the amounts owing to the Noteholders.

The Issuer is a holding company

The Issuer is the parent company of the Group. The operations of the Group are conducted by the operating subsidiaries of the Issuer. Accordingly, creditors of a subsidiary would have to be paid in full before sums would be available to the shareholders of that subsidiary and thereafter (by the payment of dividends to the Issuer) to Noteholders (except to the extent that payments are made by the Guarantor directly to Noteholders under the Guarantee).

No guarantee or other contractual support from The Royal Bank of Scotland Group plc

On the Issue Date, the Issuer, the Guarantor and the Issuer's other subsidiaries are subsidiaries of The Royal Bank of Scotland Group plc. Neither The Royal Bank of Scotland Group plc nor any of its subsidiaries (other than the Issuer and the Guarantor) is an obligor in respect of the Notes or is otherwise providing any form of credit support for the Notes.

See also "*—The RBS Group has a legal obligation to divest its controlling interest in the Group by the end of 2013 and completely divest by the end of 2014*" relating to the requirement of RBS Group to divest its insurance business.

Change of law

The Conditions are based on English law in effect as at the date of issue of the Notes. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice after the date of issue of the Notes.

RISKS RELATED TO THE MARKET GENERALLY

The secondary market generally

Although application has been made to admit the Notes to trading on the Market, the Notes have no established trading market and one may never develop. If a market does develop, it may not be liquid. Therefore, investors may not be able to sell their Notes easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. Illiquidity may have a severely adverse effect on the market value of the Notes.

Exchange rate risks and exchange controls

Payments of principal and interest on the Notes will be made in sterling. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "**Investor's Currency**") other than sterling. These include the risk that exchange rates may significantly change (including changes due to devaluation of sterling or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to sterling would decrease (1) the Investor's Currency-equivalent yield on the Notes, (2) the Investor's Currency equivalent value of the principal payable on the Notes and (3) the Investor's Currency equivalent market value of the Notes. Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.

Interest rate risks

The Notes bear interest at a fixed rate up to (but excluding) the First Call Date. An investment in the Notes during that time involves the risk that subsequent changes in market interest rates may adversely affect the value of the Notes.

Payments on the Notes may be subject to U.S. Foreign Account Tax Compliance Act Withholding

The Issuer, the Guarantor and other financial institutions through which payments on the Notes are made may be required to withhold U.S. tax at a rate of 30 per cent. on all, or a portion of, payments made after 31 December 2016 in respect of any Notes which are treated as equity for U.S. federal tax purposes pursuant to Sections 1471 through 1474 of the U.S. Internal Revenue Code ("**FATCA**") or similar law implementing an intergovernmental approach to FATCA. This withholding tax may be triggered if (i) the Issuer is a foreign financial institution ("**FFI**") (as defined in FATCA) that enters into and complies with an agreement with the U.S. Internal Revenue Service ("**IRS**") to provide certain information on its account holders (making the Issuer a "**Participating FFI**"), (ii) the Issuer has a positive "passthru payment percentage" (as determined under FATCA), and (iii)(a) an investor does not provide information sufficient for the relevant Participating FFI to determine whether the investor is a U.S. person or should otherwise be treated as holding a "United States Account" of the Issuer, or (b) any FFI that is an investor, or through which payment on the Notes is made, is not a Participating FFI.

The application of FATCA to interest, principal or other amounts paid with respect to the Notes is not clear. If an amount in respect of U.S. withholding tax were to be deducted or withheld from interest, principal or other payments on the Notes, neither the Issuer nor the Guarantor, nor any paying agent or any other person, would, pursuant to the Conditions of the Notes, be required to pay additional amounts as a result of such withholding or deduction. As a result, investors may, if FATCA is implemented as currently proposed by the IRS, receive less interest or principal than expected. Noteholders should consult their own tax advisers on how these rules may apply to payments they receive under the Notes.

Credit ratings may not reflect all risks

The Notes have been rated BBB+ by Standard & Poor's and Baa1 by Moody's. Standard & Poor's and Moody's are each credit rating agencies established in the European Union and registered under Regulation (EC) No 1060/2009 and each of them is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with such Regulation. The ratings may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Notes. A credit rating is not a recommendation to buy, sell or hold securities and may be revised or withdrawn by the rating agency at any time.

Legal investment considerations may restrict certain investments

The investment activities of certain investors are subject to legal investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) the Notes are legal investments for it, (2) the Notes can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of the Notes. Financial institutions should consult their legal advisers or the appropriate regulators to determine the appropriate treatment of the Notes under any applicable risk-based capital or similar rules.

EU Savings Directive

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (subject to a procedure whereby, on meeting certain conditions, the beneficial owner of the interest or other income may request that no tax be withheld), the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries. A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

The European Commission has proposed certain amendments to Directive 2003/48/EC which may, if implemented, amend or broaden the scope of the requirements described above.

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Note as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying Agent in a Member State that is not obliged to withhold or deduct tax pursuant to Directive 2003/48/EC.

CONDITIONS OF THE NOTES

The following is the text of the Conditions of the Notes which (subject to modification and except for the paragraphs in italics) will be endorsed on the Certificates issued in respect of the Notes:

The £500,000,000 Fixed/Floating Rate Guaranteed Subordinated Notes due 2042 (the "**Notes**", which expression shall in these Conditions, unless the context otherwise requires, include any further notes issued pursuant to Condition 18 and forming a single series with the Notes) of Direct Line Insurance Group plc (the "**Issuer**") are constituted by a Trust Deed dated 27 April 2012 (the "**Trust Deed**") made between the Issuer, U K Insurance Limited (the "**Guarantor**") as guarantor and BNY Mellon Corporate Trustee Services Limited (the "**Trustee**", which expression shall include its successor(s)) as trustee for the holders of the Notes.

The statements in these Conditions include summaries of, and are subject to, the detailed provisions of and definitions in the Trust Deed. Copies of the Trust Deed and the Agency Agreement dated 27 April 2012 (the "**Agency Agreement**") made between the Issuer, the Guarantor, The Bank of New York Mellon (Luxembourg) S.A. (the "**Registrar**", which expression shall include its successor(s)) as registrar, The Bank of New York Mellon, London Branch (the "**Principal Paying Agent**", which expression shall include its successor(s)) as principal paying agent and agent bank, the other Agents and the Trustee are available for inspection during normal business hours by the Noteholders at the registered office for the time being of the Trustee (being, as at the Issue Date, One Canada Square, London E14 5AL) and at the specified office of each of the Agents. The Noteholders are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Trust Deed and the Agency Agreement applicable to them.

The owners shown in the records of each of Euroclear Bank S.A./N.V. and Clearstream Banking, société anonyme of book-entry interests in Notes are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Trust Deed and the Agency Agreement applicable to them.

1. FORM, DENOMINATION AND TITLE

1.1 Form and Denomination

The Notes are issued in registered form in amounts of £100,000 and integral multiples of £1,000 in excess thereof (referred to as the "**principal amount**" of a Note, and references in these Conditions to "**principal**" in relation to a Note shall be construed accordingly). A note certificate (each a "**Certificate**") will be issued to each Noteholder in respect of its registered holding of Notes. Each Certificate will be numbered serially with an identifying number which will be recorded on the relevant Certificate and in the register of Noteholders which the Issuer will procure to be kept by the Registrar (the "**Register**").

1.2 Title

Title to the Notes passes only by registration in the Register. The holder of any Note will (except as otherwise required by law) be treated as its absolute owner for all purposes (whether or not it is overdue and regardless of any notice of ownership, trust or any interest or any writing on, or the theft or loss of, the Certificate issued in respect of it) and no person will be liable for so treating the holder. In these Conditions, "**Noteholder**" and (in relation to a Note) "**holder**" means the person in whose name a Note is registered in the Register.

2. TRANSFERS OF NOTES AND ISSUE OF CERTIFICATES

2.1 Transfers

A Note may be transferred by depositing the Certificate issued in respect of that Note, with the form of transfer on the back duly completed and signed, at the specified office of the Registrar or any of the Agents.

2.2 Delivery of new Certificates

Each new Certificate to be issued upon a transfer of Notes will, within five Business Days of receipt by the Registrar or the relevant Agent of the duly completed form of transfer endorsed on the relevant Certificate, be mailed by uninsured mail at the risk of the holder entitled to the Note to the address specified in the form of transfer.

Except in the limited circumstances described in this Prospectus (see "The Global Certificate—Transfers and Exchange"), owners of interests in the Notes will not be entitled to receive physical delivery of Certificates.

Where some but not all of the Notes in respect of which a Certificate is issued are to be transferred, a new Certificate in respect of the balance of Notes not so transferred will, within five Business Days of receipt by the Registrar or the relevant Agent of the original Certificate, be mailed by uninsured mail at the risk of the holder of the Notes not so transferred to the address of such holder appearing on the Register or as specified in the form of transfer.

2.3 Formalities free of charge

Registration of transfer of any Notes will be effected without charge by or on behalf of the Issuer or any Agent but upon payment (or the giving of such indemnity as the Issuer or any Agent may reasonably require) in respect of any tax or other governmental charges which may be imposed in relation to such transfer.

2.4 Closed periods

No Noteholder may require the transfer of a Note to be registered during the period of 15 days ending on the due date for any payment of principal, interest or Arrears of Interest on that Note.

2.5 Regulations

All transfers of Notes and entries on the Register will be made subject to the detailed regulations concerning transfer of Notes scheduled to the Agency Agreement. The regulations may be changed by the Issuer with the prior written approval of the Registrar and the Trustee. A copy of the current regulations will be mailed (free of charge) by the Registrar to any Noteholder who requests one.

3. STATUS OF THE NOTES

3.1 Status

The Notes constitute direct, unsecured and subordinated obligations of the Issuer and rank *pari passu* and without any preference among themselves. The rights and claims of the Noteholders are subordinated as described in Condition 3.2.

3.2 Subordination

If:

(a) at any time an order is made, or an effective resolution is passed, for the winding-up in England and Wales of the Issuer (except, in any such case, a solvent winding-up solely for the purpose of a reconstruction or amalgamation or the substitution in place of the Issuer of a successor in business of the Issuer, the terms of which reconstruction, amalgamation or substitution (A) have previously been approved in writing by the Trustee or by an Extraordinary Resolution and (B) do not provide that the Notes or any amount in respect thereof shall thereby become payable); or

(b) an administrator of the Issuer is appointed and such administrator gives notice that it intends to declare and distribute a dividend,

(the events in (a) and (b) each being an "**Issuer Winding-Up**"), the rights and claims of the Trustee (on behalf of the Noteholders but not the rights and claims of the Trustee in its personal capacity under the Trust Deed) and the Noteholders against the Issuer in respect of or arising under the Notes and the Trust Deed (including any damages awarded for breach of any obligations thereunder) will be subordinated in the manner provided in the Trust Deed to the claims of all Senior Creditors of the Issuer but shall rank: (A) at least *pari passu* with all claims of holders of all other subordinated obligations of the Issuer which constitute, and all claims relating to a guarantee or other like or similar undertaking or arrangement given or undertaken by the Issuer in respect of any obligations of any other person which constitute, or (in either case) would but for any applicable limitation on the amount of such capital constitute, Lower Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 2 Capital (issued on or after Solvency II Implementation) and all obligations which rank, or are expressed to rank, *pari passu* therewith ("**Pari Passu Securities of the Issuer**"); and (B) in priority to the claims of holders of (i) all obligations of the Issuer which constitute, and all claims relating to a guarantee or other like or similar undertaking or arrangement given or undertaken by the Issuer in respect of any obligations of any other person which constitute, or (in either case) would but for any applicable limitation on the amount of such capital constitute, Upper Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 1 Capital (including, without limitation, by virtue of the operation of any applicable grandfathering provisions) and all obligations which rank, or are expressed to rank, *pari passu* therewith and (ii) all classes of share capital of the Issuer (together, the "**Junior Securities of the Issuer**").

Nothing in this Condition 3.2 or in Condition 3.4 shall affect or prejudice the payment of the costs, charges, expenses, liabilities or remuneration of the Trustee or the rights and remedies of the Trustee in respect thereof.

3.3 Issuer Recovered Amount

In the event that any payment is made to the Trustee (other than payments made to the Trustee in its personal capacity under the Trust Deed) and/or the Noteholders in respect of the claims arising under the terms of the Notes and the Trust Deed by the liquidator or the administrator (as applicable) of the Issuer after the occurrence of an Issuer Winding-Up (any such amount paid, the "**Issuer Recovered Amount**"), any Issuer Recovered Amount shall reduce the amounts payable by the Guarantor under the Guarantee in the following manner:

(a) the Issuer Interest Portion of an Issuer Recovered Amount shall reduce any obligation of the Guarantor to make payment in respect of accrued interest and Arrears of Interest under the Guarantee by an amount equal to the Issuer Interest Portion with effect from (and including) the Issuer Recovered Amount Payment Date; and

(b) the Issuer Non-Interest Portion of an Issuer Recovered Amount shall reduce any obligation of the Guarantor to make payment in respect of principal of the Notes under the Guarantee by an amount equal to the Issuer Non-Interest Portion with effect from (and including) the Issuer Recovered Amount Payment Date, and accordingly interest shall only accrue on and be payable in respect of such reduced principal amount of the Notes from (and including) the Issuer Recovered Amount Payment Date.

3.4 Issuer Solvency Condition

Without prejudice to Condition 3.2, all payments under or arising from the Notes and the Trust Deed (other than payments made to the Trustee in its personal capacity under the Trust Deed) shall be conditional upon the Issuer being solvent at the time for payment by the Issuer, and no amount shall be payable under or arising from the Notes and the Trust Deed unless and until such time as the Issuer could make such payment and still be solvent immediately thereafter (the "**Issuer Solvency Condition**").

For the purposes of this Condition 3.4, the Issuer will be solvent if (i) it is able to pay its debts owed to Senior Creditors of the Issuer and Pari Passu Creditors of the Issuer as they fall due and (ii) its Assets exceed its Liabilities (other than Liabilities to persons who are Junior Creditors of the Issuer). A certificate as to solvency of the Issuer signed by two Directors of the Issuer or, if there is a winding-up or administration of the Issuer, by two authorised signatories of the liquidator or, as the case may be, the administrator of the Issuer shall, in the absence of manifest error be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

3.5 Set-off, etc.

By acceptance of the Notes, each Noteholder and the Trustee, on behalf of each Noteholder, will be deemed to have waived any right of set-off or counterclaim that such Noteholder might otherwise have against the Issuer in respect of or arising under the Notes whether prior to or in bankruptcy, winding-up or administration. Notwithstanding the preceding sentence, if any of the rights and claims of any Noteholder in respect of or arising under the Notes are discharged by set-off, such Noteholder will immediately pay an amount equal to the amount of such discharge to the Issuer or, if applicable, the liquidator, trustee, receiver or administrator of the Issuer and, until such time as payment is made, will hold a sum equal to such amount on trust for the Issuer or, if applicable, the liquidator, trustee, receiver or administrator in the Issuer's bankruptcy, winding-up or administration. Accordingly, such discharge will be deemed not to have taken place.

4. GUARANTEE

4.1 Status

The Guarantor has (subject as provided in Conditions 4.3, 4.6, 6.3, 6.4 and 8.3) in the Trust Deed irrevocably guaranteed the due and punctual payment of all principal, interest and other sums from time to time which are (or are deemed under Condition 4.2 to be) due and payable by the Issuer in respect of the Notes and all other monies due and payable by the Issuer in respect of or under or pursuant to the Trust Deed ("**Guaranteed Amounts**"). The obligations of the Guarantor under such guarantee (the "**Guarantee**") constitute direct, unsecured and subordinated obligations of the Guarantor.

4.2 Due and payable

For the purpose only of determining whether any Guaranteed Amount is from time to time due and payable by the Issuer for the purposes of the obligations of the Guarantor under the Guarantee, any amount of principal, interest and Arrears of Interest shall be deemed to be due and payable by the Issuer on the Applicable Date regardless of whether the Issuer Solvency Condition under Condition 3.4 is satisfied or any of Conditions 6.1, 6.2, 8.2 or 8.9 apply, provided that, if any such amount is paid by the Guarantor under the Guarantee, such payment by the Guarantor shall be treated (to the extent of the amount paid) as satisfying the Trustee and any Noteholder's right to payment of any such amount under the Trust Deed and the Notes.

For the purposes of this Condition 4.2, "**Applicable Date**" means the date on which any amount of principal, interest and/or Arrears of Interest (i) becomes due and payable by the Issuer or (ii) would have become due and payable by the Issuer had the Issuer not deferred payment of the same in accordance with these Conditions.

4.3 Subordination

If:

(a) at any time an order is made, or an effective resolution is passed, for the winding-up in England and Wales of the Guarantor (except, in any such case, (i) a winding-up following the transfer of all its liabilities and obligations as principal obligor under the Guarantee to a transferee in connection with a transfer of its business pursuant to Condition 16 or (ii) a solvent winding-up solely for the purpose of a reconstruction or amalgamation or the substitution in place of the Guarantor of a successor in business of the Guarantor, the terms of which reconstruction, amalgamation or substitution (A) have previously been approved in writing by the Trustee or by an Extraordinary Resolution and (B) do not provide that the Notes or any amount in respect thereof (including under the Guarantee) shall thereby become payable); or

(b) an administrator of the Guarantor is appointed and such administrator gives notice that it intends to declare and distribute a dividend,

(the events in (a) and (b) each being a "**Guarantor Winding-Up**"), the rights and claims of the Trustee (on behalf of the Noteholders but not the rights and claims of the Trustee in its personal capacity under the Trust Deed) and the Noteholders against the Guarantor in respect of or arising under the Notes and the Trust Deed (including the Guarantee) (including any damages awarded for breach of any obligations thereunder) will be subordinated in the manner provided in the Trust Deed to the claims of all Senior Creditors of the Guarantor, but shall rank: (A) (save as specified in sub-paragraph (d) of the definition of Senior Creditors of the Guarantor) at least *pari passu* with all claims of holders of all other subordinated obligations of the Guarantor which constitute, and all claims relating to a guarantee or other like or similar undertaking or arrangement given or undertaken by the Guarantor in respect of any obligations of any other person which constitute, or (in either case) would but for any applicable limitation on the amount of such capital constitute, Lower Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 2 Capital (issued on or after Solvency II Implementation) and all obligations which rank, or are expressed to rank, *pari passu* therewith ("**Pari Passu Securities of the Guarantor**"); and (B) in priority to the claims of holders of (i) all obligations of the Guarantor which constitute, and all claims relating to a guarantee or other like or similar undertaking or arrangement given or undertaken by the Guarantor in respect of any obligations of any other person which constitute, or (in either case) would but for any applicable limitation on the amount of such capital constitute, Upper Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 1 Capital (including, without limitation, by virtue of the operation of any applicable grandfathering provisions) and all obligations which rank, or are expressed to rank, *pari passu* therewith and (ii) all classes of share capital of the Guarantor (together, the "**Junior Securities of the Guarantor**").

Nothing in this Condition 4.3 or in Condition 4.6 shall affect or prejudice the payment of the costs, charges, expenses, liabilities or remuneration of the Trustee or the rights and remedies of the Trustee in respect thereof.

4.4 Guarantor Recovered Amount

In the event that any payment is made to the Trustee (other than payments made to the Trustee in its personal capacity under the Trust Deed) and/or the Noteholders in respect of the claims under the terms of the Notes and the Trust Deed (including the Guarantee) by the liquidator or administrator (as applicable) of the Guarantor (any such amount paid, the "**Guarantor Recovered Amount**"), any Guarantor Recovered Amount shall reduce the amounts payable by the Issuer under the terms of the Notes and the Trust Deed in the following manner:

(i) the Guarantor Interest Portion of a Guarantor Recovered Amount shall reduce any obligation of the Issuer to make payment in respect of accrued interest and Arrears of Interest under the Notes and the Trust Deed by an amount equal to the Guarantor Interest Portion with effect from (and including) the Guaranteed Recovered Amount Payment Date; and

(ii) the Guarantor Non-Interest Portion of a Guarantor Recovered Amount shall reduce any obligation of the Issuer to make payment in respect of principal of the Notes under the Notes and the Trust Deed by an amount equal to the Guarantor Non-Interest Portion with effect from (and including) the Guarantor Recovered Amount Payment Date, and accordingly interest shall only accrue on and be payable in respect of such reduced principal amount of the Notes from (and including) the Guarantor Recovered Amount Payment Date.

4.5 Obligations of the Guarantor upon an Issuer Winding-Up

In the event of an Issuer Winding-Up, the Guarantor undertakes under the Guarantee to pay the Guaranteed Amounts on the basis that such amounts are and will be due for payment under the terms of the Notes and the Trust Deed as if the Issuer Winding-Up had not occurred and provided that no amount shall be deemed due and payable by the Issuer for the purpose of the Guarantee if such amount only became due and payable by the Issuer under the terms of the Notes as a result of the occurrence of such Issuer Winding-Up. In the event that any Issuer Recovered Amount is paid to the Noteholders (or the Trustee on their behalf) in the Issuer Winding-Up, such Issuer Recovered Amount will reduce the amounts payable by the Guarantor in respect of the Notes and the Trust Deed (including the Guarantee) to the extent and in the manner provided in Condition 3.3.

In addition, the Guarantor shall have the rights and benefits of all the provisions applicable to the Issuer in the Conditions and the Trust Deed including, without limitation, the Issuer's ability to redeem, vary, substitute or purchase the Notes in the circumstances set out in Conditions 8.5, 8.6 and 8.7 and, accordingly, all references in the Conditions and the Trust Deed to the Issuer shall, to the extent necessary to confer such rights and/or benefits, be construed as references to the Guarantor.

4.6 Guarantor Solvency Condition

Without prejudice to Condition 4.3, all payments under or arising from the Guarantee shall be conditional upon the Guarantor being solvent at the time for payment by the Guarantor, and no amount shall be payable under or arising from the Guarantee unless and until such time as the Guarantor could make such payment and still be solvent immediately thereafter (the "**Guarantor Solvency Condition**").

For the purposes of this Condition 4.6, the Guarantor will be solvent if (i) it is able to pay its debts owed to Senior Creditors of the Guarantor and Pari Passu Creditors of the Guarantor as they fall due and (ii) its Assets exceed its Liabilities (other than Liabilities to persons who are Junior Creditors of the Guarantor). A certificate as to solvency of the Guarantor signed by two Directors of the Guarantor or, if there is a winding-up or administration of the Guarantor, by two authorised signatories of the liquidator or, as the case may be, the administrator of the Guarantor shall, in the absence of manifest error be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

4.7 Set-off, etc.

By acceptance of the Notes, each Noteholder and the Trustee, on behalf of each Noteholder, will be deemed to have waived any right of set-off or counterclaim that such Noteholder might otherwise have against the Guarantor in respect of or arising under the Notes or the Guarantee whether prior to or in bankruptcy, winding-up or administration. Notwithstanding the preceding sentence, if any of the rights and claims of any Noteholder in respect of or arising under the Notes or the Guarantee are discharged by set-off, such Noteholder will immediately pay an amount equal to the amount of such discharge to the Guarantor or, if applicable, the liquidator, trustee, receiver or administrator of the Guarantor and, until such time as payment is made, will hold a sum equal to such amount on trust for the Guarantor or, if applicable, the liquidator, trustee, receiver or administrator in the Guarantor's bankruptcy, winding-up or administration. Accordingly, such discharge will be deemed not to have taken place.

5. INTEREST

5.1 Interest Rate

Each Note bears interest on its principal amount at the applicable Interest Rate from (and including) the Issue Date in accordance with provisions of this Condition 5.

Subject to Conditions 3.4, 4.6 and 6, interest shall be payable on the Notes semi-annually in arrear on each Interest Payment Date, in each case as provided in this Condition 5.

5.2 Interest Accrual

Interest shall cease to accrue on each Note on the due date for redemption (which due date shall, in the case of deferral of a redemption date in accordance with Condition 8.2 or 8.3, be the latest date to which redemption of the Notes is so deferred) unless payment is improperly withheld or refused, in which event interest shall continue to accrue (in each case, both before and after judgment) as provided in the Trust Deed.

5.3 Fixed Interest Rate

For the Fixed Rate Interest Period, the Notes bear interest at the rate of 9.250 per cent. per annum (the "**Fixed Interest Rate**").

Where it is necessary to compute an amount of interest in respect of any Note during the Fixed Rate Interest Period, such interest shall be calculated on the basis of the actual number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Issue Date) to (but excluding) the relevant payment date divided by two times the actual number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Issue Date) to (but excluding) the next (or first) scheduled Interest Payment Date.

5.4 Floating Interest Rate

From (and including) the First Call Date, the Notes will bear interest at a floating rate of interest (the "**Floating Interest Rate**"). The Floating Interest Rate in respect of each Interest Period commencing on or after the First Call Date will be determined by the Principal Paying Agent on the basis of the following provisions:

(a) On each Interest Determination Date, the Principal Paying Agent will determine the offered rate (expressed as a rate per annum) for six-month sterling deposits as at 11.00 a.m. (London time) on such Interest Determination Date, as displayed on Reuters page LIBOR01 (or such other page or pages as may replace it for the purpose of displaying such information). The Floating Interest Rate for the Interest Period commencing on the Interest Determination Date shall be such offered rate as determined by the Principal Paying Agent plus the Margin.

(b) If the offered rate does not appear on the relevant page at the relevant time, or if the relevant page is unavailable, the Principal Paying Agent will, on such date, request the principal London office of the Reference Banks to provide the Principal Paying Agent with its offered quotation to leading banks in the London interbank market for six-month sterling deposits as at 11.00 a.m. (London time) on the Interest Determination Date in question. If at least two of the Reference Banks provide the Principal Paying Agent with such offered quotations, the Floating Interest Rate for the Interest Period shall be the rate determined by the Principal Paying Agent to be the arithmetic mean (rounded if necessary to the nearest one hundred thousandth of a percentage point (0.000005 per cent. being rounded upwards)) of such offered quotations plus the Margin.

(c) If on any Interest Determination Date to which the provisions of sub-paragraph (b) above apply, one only or none of the Reference Banks provides the Principal Paying Agent with such a quotation, the Floating Interest Rate for the Interest Period shall be the rate which the Principal Paying Agent determines to be the aggregate of the Margin and the arithmetic mean (rounded, if necessary, to the nearest one hundred thousandth of a percentage point (0.000005 per cent. being rounded upwards)) of the sterling lending rates which leading banks in London selected by the Principal Paying Agent are quoting, on the relevant Interest Determination Date, to leading banks in Europe for a period of six months, except that, if the banks so selected by the Principal Paying Agent are not quoting as mentioned above, the Floating Interest Rate for such Interest Period shall be either (1) the Floating Interest Rate in effect for the last preceding Interest Period to which one of the preceding sub-paragraphs of this Condition 5.4 shall be applied or (2) if none, 9.250 per cent. per annum.

5.5 Determination of Floating Interest Rate and Calculation of Floating Interest Amounts

The Principal Paying Agent will, as soon as practicable after 11.00 a.m. (London time) on each Interest Determination Date, determine the Floating Interest Rate in respect of the Interest Period commencing on that Interest Determination Date and calculate the amount of interest payable in respect of each Note on the Interest Payment Date for that Interest Period (the "**Floating Interest Amount**") by applying the Floating Interest Rate for such Interest Period to the denomination of such Note, multiplying such sum by the actual number of days in the Interest Period concerned divided by 365 (or, in the case of an Interest Payment Date falling in a leap year, 366) and, if necessary, rounding the resultant figure to the nearest £0.01 (£0.005 being rounded upwards).

5.6 Publication of Floating Interest Rate and Floating Interest Amounts

The Issuer shall cause notice of the Floating Interest Rate determined in accordance with this Condition 5 in respect of each relevant Interest Period, the Floating Interest Amount and the relevant date scheduled for payment to be given to the Trustee, the Paying Agents, any stock exchange or other relevant authority on which the Notes are for the time being listed or admitted to trading, in each case as soon as practicable after its determination but in any event not later than the fourth Business Day thereafter. The Floating Interest Amount, the Floating Interest Rate and the date scheduled for payment so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without notice in the event of any extension or shortening of the relevant period in accordance with these Conditions or in the event of proven or manifest error.

5.7 Determinations or calculation by Trustee

The Trustee (or an agent appointed by it) shall, if the Principal Paying Agent does not at any relevant time and for any reason determine the Floating Interest Rate and/or the Floating Interest Amount on the Notes in accordance with this Condition 5, determine the Floating Interest Rate in respect of the relevant Interest Period at such rate as, in its absolute discretion (having such regard as it shall think fit to the procedures prescribed in this Condition 5), it shall deem fair and reasonable in all the circumstances and such determination shall be deemed to be a determination thereof by the Principal Paying Agent.

5.8 Principal Paying Agent

So long as any of the Notes remains outstanding, the Issuer and the Guarantor will maintain a Principal Paying Agent. The Issuer and the Guarantor may, with the prior written approval of the Trustee, from time to time replace the Principal Paying Agent with another leading investment, merchant or commercial bank in London. If the Principal Paying Agent is unable or unwilling to continue to act as the Principal Paying Agent or (without prejudice to Condition 5.7) fails duly to determine the Floating Interest Rate in respect of any Interest Period as provided in Condition 5.4, the Issuer and the Guarantor shall forthwith appoint another leading investment, merchant or commercial bank in London approved in writing by the Trustee to act as such in its place.

5.9 Determinations of Principal Paying Agent or Trustee binding

All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of this Condition 5, whether by the Principal Paying Agent or the Trustee (or its agent), shall (in the absence of manifest error) be binding on the Issuer, the Guarantor, the Principal Paying Agent, the Trustee, the Paying Agents and all Noteholders and (in the absence of wilful default and bad faith) no liability to the Noteholders, the Issuer or the Guarantor shall attach to the Principal Paying Agent or the Trustee in connection with the exercise or non-exercise by them of any of their powers, duties and discretions.

6. DEFERRAL OF INTEREST

6.1 Issuer Optional Deferral of Interest

The Issuer may elect in respect of any Optional Interest Payment Date, by notice to the Noteholders, the Trustee and the Principal Paying Agent pursuant to Condition 6.9, to defer payment of all (but not some only) of the interest accrued to that date and the Issuer shall not have any obligation to make such payment on that date.

6.2 Issuer Mandatory Deferral of Interest

Payment of interest on the Notes by the Issuer will be mandatorily deferred on each Mandatory Interest Deferral Date. The Issuer shall notify the Noteholders, the Trustee and the Principal Paying Agent of any Mandatory Interest Deferral Date in accordance with Condition 6.9 (provided that failure to make such notification shall not oblige the Issuer to make payment of such interest, or cause the same to become due and payable, on such date).

A certificate signed by two Directors of the Issuer confirming that (a) a Regulatory Deficiency Interest Deferral Event has occurred and is continuing, or would occur if payment of interest on the Notes were to be made or (b) a Regulatory Deficiency Interest Deferral Event has ceased to occur and/or payment of interest on the Notes would not result in a Regulatory Deficiency Interest Deferral Event occurring, shall, in the absence of manifest error, be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

6.3 Guarantor Optional Deferral of Guaranteed Amounts in respect of interest

If a payment of any Guaranteed Amounts in respect of interest would (but for this Condition 6.3) become due and payable under the Guarantee on a date which is a Guarantor Optional Interest Payment Date, the Guarantor may elect, by notice to the Noteholders, the Trustee and the Principal Paying Agent pursuant to Condition 6.9 below, to defer payment of all (but not some only) of such Guaranteed Amounts and the Guarantor shall not have any obligation to make payment of the same on that date.

6.4 Guarantor Mandatory Deferral of Guaranteed Amounts in respect of interest

Any Guaranteed Amounts in respect of interest which would otherwise become due and payable under the Guarantee on a date which is a Guarantor Mandatory Interest Deferral Date will be mandatorily deferred. The Guarantor shall notify the Noteholders, the Trustee and the Principal Paying Agent of any such deferral in accordance with Condition 6.9 (provided that failure to make such notification shall not oblige the Guarantor to make payment of such Guaranteed Amounts, or cause the same to become due and payable, on such date).

A certificate signed by two Directors of the Guarantor confirming that (a) a Guarantor Regulatory Deficiency Interest Deferral Event has occurred and is continuing, or would occur if payment of the relevant Guaranteed Amounts were to be made or (b) a Guarantor Regulatory Deficiency Interest Deferral Event has ceased to occur and/or payment of relevant Guaranteed Amounts would not result in a Guarantor Regulatory Deficiency Interest Deferral Event occurring, shall, in the absence of manifest error, be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

6.5 No default

Notwithstanding any other provision in these Conditions or in the Trust Deed, neither:

(a) the deferral by the Issuer of any payment of interest (i) on an Optional Interest Payment Date in accordance with Condition 6.1, (ii) on a Mandatory Interest Deferral Date in accordance with Condition 6.2 or (iii) as a result of the application of the Issuer Solvency Condition in accordance with Condition 3.4; nor

(b) the deferral by the Guarantor of any payment of any Guaranteed Amounts in respect of interest (i) on a Guarantor Optional Interest Payment Date in accordance with Condition 6.3, (ii) on a Guarantor Mandatory Interest Deferral Date in accordance with Condition 6.4 or (iii) as a result of the application of the Guarantor Solvency Condition in accordance with Condition 4.6,

will constitute a default by the Issuer or the Guarantor and will not give Noteholders or the Trustee any right to accelerate repayment of the Notes or take any enforcement action under the Notes or the Trust Deed (including the Guarantee).

6.6 Arrears of Interest

Any interest on the Notes not paid on an Interest Payment Date as a result of:

(a) the exercise by the Issuer of its discretion to defer such payment of interest pursuant to Condition 6.1, the obligation of the Issuer to defer such payment of interest pursuant to Condition 6.2 or the operation of the Issuer Solvency Condition described in Condition 3.4; and

(b) the exercise by the Guarantor of its discretion to defer payment of Guaranteed Amounts in respect of such interest pursuant to Condition 6.3, the obligation of the Guarantor to defer payment of Guaranteed Amounts in respect of such interest pursuant to Condition 6.4 or the operation of the Guarantor Solvency Condition described in Condition 4.6,

shall (without double-counting), to the extent and so long as the same remains unpaid, constitute "**Arrears of Interest**". Arrears of Interest shall not themselves bear interest.

6.7 Payment of Arrears of Interest by the Issuer

Any Arrears of Interest may (subject to Condition 3.4 and to satisfaction of the Regulatory Clearance Condition) be paid by the Issuer in whole or in part at any time upon the expiry of not less than 14 days' notice to such effect given by the Issuer to the Trustee, the Principal Paying Agent and the Noteholders in accordance with Condition 13 and in any event will become due and payable by the Issuer (subject, in the case of (a) and (c) below, to Condition 3.4 and to satisfaction of the Regulatory Clearance Condition) in whole (and not in part) upon the earliest of the following dates:

(a) the next Interest Payment Date which is not a Mandatory Interest Deferral Date on which payment of interest in respect of the Notes is made; or

(b) the date on which an Issuer Winding-Up occurs; or

(c) the date fixed for any redemption or purchase of Notes pursuant to Condition 8 (subject to any deferral of such redemption date pursuant to Condition 8.2) or Condition 11.

6.8 Payment of Arrears of Interest by the Guarantor

Any Arrears of Interest may (subject to Condition 4.6 and to satisfaction of the Regulatory Clearance Condition) be paid by the Guarantor in whole or in part at any time upon the expiry of not less than 14 days' notice to such effect given by the Guarantor to the Trustee, the Principal Paying Agent and the Noteholders in accordance with Condition 13 and in any event will become due and payable by the Guarantor (subject, in the case of (a) and (c) below, to Condition 4.6 and to satisfaction of the Regulatory Clearance Condition) in whole (and not in part) upon the earliest of the following dates:

(a) the next Interest Payment Date which is not a Guarantor Mandatory Interest Deferral Date on which payment of Guaranteed Amounts in respect of interest is made; or

(b) the date on which a Guarantor Winding-Up occurs; or

(c) the date fixed for any redemption or purchase of Notes by or on behalf of the Issuer pursuant to Condition 8 (subject to any deferral by the Guarantor of payments of Guaranteed Amounts in connection with a redemption or purchase of the Notes date pursuant to Condition 8.3) or Condition 11.

6.9 Notice of Deferral

(a) The Issuer shall notify the Trustee, the Principal Paying Agent and the Noteholders in writing in accordance with Condition 13 not less than 5 Business Days prior to an Interest Payment Date:

(i) if that Interest Payment Date is an Optional Interest Payment Date in respect of which the Issuer elects to defer interest as provided in Condition 6.1 above; or

(ii) if that Interest Payment Date is a Mandatory Interest Deferral Date and specifying that interest will not be paid because a Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment of interest was made on such Interest Payment Date, provided that if a Regulatory Deficiency Interest Deferral Event occurs less than 5 Business Days prior to an Interest Payment Date, the Issuer shall give notice of the interest deferral in accordance with Condition 13 as soon as reasonably practicable following the occurrence of such event.

(b) The Guarantor shall notify the Trustee, the Principal Paying Agent and the Noteholders in writing in accordance with Condition 13 not less than 4 Business Days prior to an Interest Payment Date in respect of which Guaranteed Amounts in respect of interest are scheduled to be paid:

(i) if that Interest Payment Date is a Guarantor Optional Interest Payment Date in respect of which the Guarantor elects to defer payment of the relevant Guaranteed Amounts as provided in Condition 6.3 above; or

(ii) if that Interest Payment Date is a Guarantor Mandatory Interest Deferral Date and specifying that relevant Guaranteed Amounts will not be paid because a Guarantor Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment of relevant Guaranteed Amounts was made on such Interest Payment Date, provided that if a Guarantor Regulatory Deficiency Interest Deferral Event occurs less than 4 Business Days prior to such Interest Payment Date, the Guarantor shall give notice of the deferral in accordance with Condition 13 as soon as reasonably practicable following the occurrence of such event.

7. PAYMENTS

7.1 Payments in respect of Notes

Payment of principal and interest will be made by transfer to the registered account of the relevant Noteholder or by sterling cheque drawn on a bank that processes payments in sterling mailed to the registered address of the relevant Noteholder if it does not have a registered account. Payments of principal, and payments of interest and Arrears of Interest due at the time of redemption of the Notes, will only be made against surrender of the relevant Certificate at the specified office of any of the Agents. Save as provided in the previous sentence, interest and Arrears of Interest due for payment on the Notes will be paid to the holder shown on the Register at the close of business on the date (the "**record date**") being the second day before the due date for the relevant payment.

For the purposes of this Condition 7, (i) a Noteholder's registered account means the sterling account maintained by or on behalf of it with a bank that processes payments in sterling, details of which appear on the Register at the close of business, in the case of principal, and of interest and Arrears of Interest due at the time of redemption of the Notes, on the second Business Day before the due date for payment and, in the case of any other payment of interest and Arrears of Interest, on the relevant record date, and (ii) a Noteholder's registered address means its address appearing on the Register at that time.

7.2 Payments subject to applicable laws

Payments on Notes are subject in all cases to any fiscal or other laws and regulations applicable in the place of payment, but without prejudice to the provisions of Condition 9.

7.3 No commissions

No commissions or expenses shall be charged to the Noteholders in respect of any payments made in accordance with this Condition 7.

7.4 Payment on Business Days

Where payment is to be made by transfer to a registered account, payment instructions (for value the due date or, if that is not a Business Day, for value the first following day which is a Business Day) will be initiated and, where payment is to be made by cheque, the cheque will be mailed, on the Business Day preceding the due date for payment or, in the case of a payment of principal, or of a payment of interest or Arrears of Interest due at the time of redemption of the Notes, if later, on the Business Day on which the relevant Certificate is surrendered at the specified office of an Agent.

Noteholders will not be entitled to any interest or other payment for any delay after the due date in receiving the amount due if the due date is not a Business Day, if the Noteholder is late in surrendering its Certificate (in circumstances where it is required to do so) or if a cheque mailed in accordance with this Condition arrives after the due date for payment.

7.5 Partial payments

If the amount of principal or interest which is due on the Notes is not paid in full, the Registrar will annotate the Register with a record of the amount of principal or interest in fact paid.

7.6 Agents

The names of the initial Agents and their initial specified offices are set out at the end of these Conditions. The Issuer and the Guarantor reserve the right, subject to the prior written approval of the Trustee, at any time to vary or terminate the appointment of any Agent and to appoint additional or other Agents, provided that they will at all times maintain:

(a) a Principal Paying Agent;

(b) an Agent (which may be the Principal Paying Agent) having a specified office in a European city;

(c) a Paying Agent in a Member State of the European Union that is not obliged to withhold or deduct tax pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; and

(d) a Registrar.

Notice of any termination or appointment and of any changes in specified offices of any of the Agents will be given to the Noteholders promptly by the Issuer or the Guarantor in accordance with Condition 13.

8. REDEMPTION, SUBSTITUTION, VARIATION AND PURCHASE

8.1 Redemption at Maturity

Subject to Conditions 8.2 and 8.9 and to satisfaction of the Regulatory Clearance Condition, unless previously redeemed or purchased and cancelled as provided below, the Issuer will redeem the Notes at their principal amount on the Interest Payment Date falling in April 2042 (the "**Maturity Date**") together with any Arrears of Interest and any other accrued and unpaid interest to (but excluding) the Maturity Date.

8.2 Issuer deferral of redemption date

(a) No Notes shall be redeemed on the Maturity Date pursuant to Condition 8.1 or prior to the Maturity Date pursuant to Conditions 8.5, 8.6 or 8.7 if a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if redemption is made pursuant to Condition 8.

(b) The Issuer shall notify the Trustee, the Principal Paying Agent and the Noteholders in accordance with Condition 13 no later than 5 Business Days prior to any date set for redemption of the Notes if such redemption is to be deferred in accordance with Condition 8.2(a), provided that if a Regulatory Deficiency Redemption Deferral Event occurs less than 5 Business Days prior to the date set for redemption, the Issuer shall give notice of such deferral in accordance with Condition 13 as soon as reasonably practicable following the occurrence of such event.

(c) If redemption of the Notes does not occur on the Maturity Date or, as appropriate, the date specified in the notice of redemption by the Issuer under Condition 8.5, 8.6 or 8.7 as a result of Condition 8.2(a) above, the Issuer shall (subject, in the case of (i) and (ii) below only, to Condition 3.4 and to satisfaction of the Regulatory Clearance Condition) redeem such Notes at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest (in each case, to the extent that such amounts have not at such time already been paid by or otherwise recovered from the Guarantor), upon the earliest of:

(i) the date falling 10 Business Days after the date the Regulatory Deficiency Redemption Deferral Event has ceased (unless on such 10th Business Day a further Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or redemption of the Notes on such date would result in a Regulatory Deficiency Redemption Deferral Event occurring, in which case the provisions of Condition 8.2(a) and this Condition 8.2(c) will apply *mutatis mutandis* to determine the due date for redemption of the Notes); or

(ii) the date falling 10 Business Days after the FSA has agreed to the repayment or redemption of the Notes; or

(iii) the date on which an Issuer Winding-Up occurs.

(d) If Condition 8.2(a) does not apply, but redemption of the Notes does not occur on the Maturity Date or, as appropriate, the date specified in the notice of redemption by the Issuer under Condition 8.5, 8.6 or 8.7 as a result of the Issuer Solvency Condition not being satisfied at such time, subject to satisfaction of the Regulatory Clearance Condition, such Notes shall be redeemed at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest (in each case, to the extent that such amounts have not at such time already been paid by or otherwise recovered from the Guarantor) on the 10th Business Day immediately following the day that (A) the Issuer is solvent for the purposes of Condition 3.4 and (B) the redemption of the Notes would not result in the Issuer ceasing to be solvent for the purposes of Condition 3.4, provided that if on such Business Day specified for redemption a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing, or would occur if the Notes were to be redeemed, then the Notes shall not be redeemed on such date and Conditions 3.4 and 8.2(c) shall apply *mutatis mutandis* to determine the due date for redemption of the Notes.

(e) A certificate signed by two Directors of the Issuer confirming that (A) a Regulatory Deficiency Redemption Deferral Event has occurred and is continuing, or would occur if redemption of the Notes were to be made or (B) a Regulatory Deficiency Redemption Deferral Event has ceased to occur and/or redemption of the Notes would not result in a Regulatory Deficiency Redemption Deferral Event occurring, shall, in the absence of manifest error, be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

8.3 Guarantor deferral of redemption date

(a) The obligations of the Guarantor under the Guarantee to make payment of Guaranteed Amounts in respect of principal, interest or any other amount in relation to the redemption of the Notes will be mandatorily deferred if a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if such payment is made.

(b) The Guarantor shall notify the Trustee, the Principal Paying Agent and the Noteholders in accordance with Condition 13 no later than 5 Business Days after the date on which the Guarantor becomes aware of its obligation to make payment of Guaranteed Amounts in respect of principal, interest or any other amount in relation to the redemption of the Notes and if a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if such payment was made.

(c) If the obligations of the Guarantor under the Guarantee to make payment in relation to the redemption of the Notes are mandatorily deferred in accordance with Condition 8.3(a), such payment will (to the extent that the relevant amounts have not at such time already been paid by or otherwise recovered from the Issuer) become due and payable by the Guarantor (subject, in the case of (i) and (ii) below only, to Condition 4.6 and to satisfaction of the Regulatory Clearance Condition) in whole (and not in part) upon the earliest of:

(i) the date falling 10 Business Days after the date the Guarantor Regulatory Deficiency Redemption Deferral Event has ceased (unless on such 10th Business Day a further Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or payment under the Guarantee in relation to the redemption of Notes on such date would result in a Guarantor Regulatory Deficiency Redemption Deferral Event occurring, in which case the provisions of Condition 8.3(a) and this Condition 8.3(c) will apply *mutatis mutandis* to determine the due date for payment of such amounts); or

(ii) the date falling 10 Business Days after the FSA has agreed to the payment by the Guarantor of Guaranteed Amounts in connection with redemption of the Notes by the Issuer; or

(iii) the date on which a Guarantor Winding-Up occurs.

(d) If Condition 8.3(a) does not apply, but the obligations of the Guarantor under the Guarantee to make payment of any Guaranteed Amounts in relation to the redemption of the Notes are mandatorily deferred as a result of the Guarantor Solvency Condition not being satisfied at such time, subject to satisfaction of the Regulatory Clearance Condition, such obligations shall be payable (to the extent that the relevant amounts have not at such time already been paid by or otherwise recovered from the Issuer) on the 10th Business Day immediately following the day that (A) the Guarantor is solvent for the purposes of Condition 4.6 and (B) the payment of such Guaranteed Amounts would not result in the Guarantor ceasing to be solvent for the purposes of Condition 4.6, provided that if on such Business Day specified for redemption a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing, or would occur if such obligations were to be paid, then such obligations shall not be paid on such date and Conditions 4.6 and 8.3(c) shall apply *mutatis mutandis* to determine the due date for payment of such Guaranteed Amounts.

(e) A certificate signed by two Directors of the Guarantor confirming that (a) a Guarantor Regulatory Deficiency Redemption Deferral Event has occurred and is continuing or would occur if payment were to be made under the Guarantee in relation to the redemption of Notes or (b) a Guarantor Regulatory Deficiency Redemption Deferral Event has ceased to occur and payment under the Guarantee in relation to the redemption of Notes would not result in a Guarantor Regulatory Deficiency Redemption Deferral Event occurring shall, in the absence of manifest error, be treated and accepted by the Issuer, the Guarantor, the Trustee, the Noteholders and all other interested parties as correct and sufficient evidence thereof, shall be binding on all such persons and the Trustee shall be entitled to rely on such certificate without liability to any person.

8.4 Deferral of redemption not a default

Notwithstanding any other provision in these Conditions or in the Trust Deed, the deferral of redemption of the Notes (including deferral of payment of any Guaranteed Amounts under the Guarantee in respect of the redemption of the Notes) in accordance with Condition 3.4, 4.6, 8.2 or 8.3 will not constitute a default by the Issuer or the Guarantor and will not give Noteholders or the Trustee any right to accelerate the Notes or take any enforcement action under the Notes or the Trust Deed (including the Guarantee).

8.5 Redemption at the option of the Issuer

Subject to Conditions 8.2(a) and 8.9 the Issuer may, having given:

(a) not less than 15 nor more than 30 days' notice to the Noteholders in accordance with Condition 13; and

(b) notice to the Registrar, the Principal Paying Agent and the Trustee not less than three days before the giving of the notice referred to in (a);

(which notice shall be irrevocable and shall specify the date fixed for redemption), redeem all (but not some only) of the Notes, on the First Call Date or on any following Interest Payment Date at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest to (but excluding) the date of redemption.

8.6 Redemption, variation or substitution for taxation reasons

Subject to Conditions 8.2(a) and 8.9 if the Issuer satisfies the Trustee immediately before the giving of the notice referred to below that:

(a) as a result of any change in, or amendment to, the laws or regulations of a Relevant Jurisdiction, or any change in the application or official interpretation of the laws or regulations of a Relevant Jurisdiction, which change or amendment becomes effective after 25 April 2012, on the next Interest Payment Date either (i) the Issuer would be required to pay additional amounts as provided or referred to in Condition 9; or (ii) the Guarantor would be unable for reasons outside its control to procure payment by the Issuer and in making payment itself would be required to pay such additional amounts; or (iii) the payment of interest (or any Guaranteed Amounts in respect of interest) would be treated as a "distribution" for United Kingdom tax purposes; or (iv) in respect of the payment of interest (or any Guaranteed Amounts in respect of interest), the Issuer or the Guarantor, as the case may be, would not to any material extent be entitled to have any attributable loss or non-trading deficit set against the profits of companies with which it is grouped for applicable United Kingdom tax purposes (whether under the group relief system current as at the Issue Date or any similar system or systems having like effect as may from time to time exist); and

(b) the effect of the foregoing cannot be avoided by the Issuer or, as the case may be, the Guarantor taking reasonable measures available to it,

the Issuer may at its option (without any requirement for the consent or approval of the Noteholders) and having given not less than 30 nor more than 60 days' notice to the Trustee, the Principal Paying Agent and, in accordance with Condition 13, the Noteholders (which notice shall be irrevocable) either:

(A) redeem all the Notes, but not some only, at any time at their principal amount together with any Arrears of Interest and any other accrued and unpaid interest to (but excluding) the date of redemption, provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which (i) with respect to (a)(i) and (a)(ii), the Issuer or, as the case may be, the Guarantor would be obliged to pay such additional amounts; (ii) with respect to (a)(iii), the payment of interest (or Guaranteed Amounts in respect of interest) would be so treated as a "distribution"; or (iii) with respect to (a)(iv), the Issuer or the Guarantor, as the case may be, would not to any material extent be entitled to have the loss or non-trading deficit set against the profits as provided in (a)(iv), in each case were a payment in respect of the Notes then due; or

(B) substitute at any time all (but not some only) of the Notes for, or vary the terms of the Notes so that they become or remain, Qualifying Dated Tier 2 Securities, and the Trustee shall (subject to the receipt by it of the certificates of the Directors referred to in Condition 8.9 below and in the definition of Qualifying Dated Tier 2 Securities) agree to such substitution or variation,

Upon expiry of such notice the Issuer shall either redeem, vary or substitute the Notes, as the case may be.

8.7 Redemption, substitution or variation at the option of the Issuer due to a Capital Disqualification Event or Ratings Methodology Event

(a) Subject to Conditions 8.2(a) and 8.9, if at any time a Capital Disqualification Event or a Ratings Methodology Event has occurred and is continuing, or the Issuer satisfies the Trustee that, as a result of any change in, or amendment to, or any change in the application or official interpretation of, any applicable law, regulation, ratings methodology or other official publication, the same will occur within a period of six months, then the Issuer may, having given not less than 30 nor more than 60 days' notice to the Noteholders in accordance with Condition 13, the Trustee and the Principal Paying Agent, which notice must be given during the Notice Period and shall be irrevocable, either:

(i) at any time (in the case of a Capital Disqualification Event), or at any time on or after the fifth anniversary of the Issue Date (in the case of a Ratings Methodology Event), redeem all (but not some only) of the Notes at their principal amount, together with any Arrears of

Interest and any other accrued and unpaid interest to (but excluding) the date of redemption; or

(ii) at any time substitute all (and not some only) of the Notes for, or vary the terms of the Notes so that they become or remain (A) in the case of a substitution or variation in connection with a Capital Disqualification Event, Qualifying Dated Tier 2 Securities, or (B) in the case of a substitution or variation in connection with a Ratings Methodology Event, Rating Agency Compliant Securities, and in either case the Trustee shall (subject to the receipt by it of the certificates of the Directors referred to in Condition 8.9 below, in the definition of 'Qualifying Dated Tier 2 Securities' and (in the case of a substitution or variation in connection with a Ratings Methodology Event) in the definition of 'Rating Agency Compliant Securities') agree to such substitution or variation.

Upon expiry of such notice the Issuer shall either redeem, vary or substitute the Notes, as the case may be.

(b) For the purposes of this Condition 8.7, "**Notice Period**" means the period commencing on the date on which the relevant Capital Disqualification Event or relevant Ratings Methodology Event (as the case may be) first occurs (or, as applicable, the date on which the Issuer satisfies the Trustee that the same will occur within a period of six months) and ending on the thirtieth calendar day following satisfaction of the Regulatory Clearance Condition in respect of the redemption, substitution or variation which is the subject of the notice to which the Notice Period relates.

(c) For the purposes of (b) above, if a Ratings Methodology Event occurs at any time before the fifth anniversary of the Issue Date and the Issuer does not, at that time, elect to substitute or vary the terms of the Notes in accordance with (a)(ii) above, such Ratings Methodology Event shall, for the purposes of determining the Notice Period for exercising the Issuer's option to redeem the Notes following a Ratings Methodology Event under (a)(i) above, be deemed to have first occurred on the date falling 30 days prior to the fifth anniversary of the Issue Date.

8.8 Trustee role on redemption, variation or substitution; Trustee not obliged to monitor

The Trustee shall (at the expense of the Issuer) use its reasonable endeavours to co-operate with the Issuer (including, but not limited to, entering into such documents or deeds as may be necessary) to give effect to substitution or variation of the Notes for or into Qualifying Dated Tier 2 Securities pursuant to Condition 8.6 or Qualifying Dated Tier 2 Securities or Rating Agency Compliant Securities (as the case may be) pursuant to Condition 8.7 above provided that the Trustee shall not be obliged to co-operate in any such substitution or variation of the terms if the securities into which the Notes are to be substituted or are to be varied or the co-operation in such substitution or variation imposes, in the Trustee's opinion, more onerous obligations upon it or exposes it to liabilities or reduces its protections. If the Trustee does not so co-operate as provided above, the Issuer may, subject as provided above, redeem the Notes as provided above.

The Trustee shall not be under any duty to monitor whether any event or circumstance has happened or exists for the purposes of this Condition 8 and will not be responsible to Noteholders for any loss arising from any failure by it to do so. Unless and until the Trustee has actual knowledge of the occurrence of any event or circumstance within this Condition 8, it shall be entitled to assume that no such event or circumstance exists.

8.9 Preconditions to redemption, variation, substitution and purchases

(a) Prior to the publication of any notice of redemption, variation or substitution pursuant to Condition 8.6 or 8.7, the Issuer shall deliver to the Trustee a certificate signed by two Directors of the Issuer stating that, as the case may be:

(i) the requirement referred to in paragraph 8.6(a) above will apply on the next Interest Payment Date and cannot be avoided by the Issuer or, as the case may be, the Guarantor taking reasonable measures available to it; or

(ii) a Capital Disqualification Event or a Ratings Methodology Event has occurred and is continuing as at the date of the certificate or, as the case may be, will occur; and

(iii) in the case of notice of a redemption before the fifth anniversary of the Issue Date, it would have been reasonable for the Issuer to conclude, judged at the time of issue of the Notes, that the circumstance entitling the Issuer to exercise the right of redemption was unlikely to occur,

and the Trustee shall accept the certificate as sufficient evidence of the satisfaction of the conditions precedent set out above, in which event it shall be conclusive and binding on the Noteholders (it being declared that the Trustee may rely absolutely on such certification without liability to any person).

(b) In addition, prior to the publication of any notice of redemption before the Maturity Date or any substitution, variation or purchase of the Notes, the Issuer or, as the case may be, the Guarantor will be required to have complied with the Regulatory Clearance Condition and be in continued compliance with Regulatory Capital Requirements. A certificate from any two Directors to the Trustee confirming such compliance shall be conclusive evidence of such compliance (it being declared that the Trustee may rely absolutely on such certification without liability to any person).

(c) Neither the Issuer nor the Guarantor shall redeem (or, as the case may be, pay any Guaranteed Amounts in respect of any redemption of) any Notes or purchase any Notes unless at the time of such redemption, payment or purchase it is, and will immediately thereafter remain (i) solvent (as such term is described in Condition 3.4 with respect to the Issuer and in Condition 4.6 with respect to the Guarantor) and (ii) in compliance with all Regulatory Capital Requirements applicable to it. A certificate from any two Directors to the Trustee confirming such compliance shall be conclusive evidence of such compliance (it being declared that the Trustee may rely absolutely on such certification without liability to any person).

8.10 Compliance with stock exchange rules

In connection with any substitution or variation of the Notes in accordance with Condition 8.6 or Condition 8.7, the Issuer and the Guarantor shall comply with the rules of any stock exchange or other relevant authority on which the Notes are for the time being listed or admitted to trading, and (for so long as the Notes are listed on the Official List of the FSA in its capacity as competent authority under the FSMA and admitted to trading on the London Stock Exchange's regulated market) shall publish a supplement in connection therewith if the Issuer and/or the Guarantor is required to do so in order to comply with Section 87G of the FSMA.

8.11 Purchases

Subject to Condition 8.9, the Issuer, the Guarantor or any of the Issuer's other Subsidiaries may at any time purchase Notes in any manner and at any price. All Notes purchased by or on behalf of the Issuer, the Guarantor or any other Subsidiary of the Issuer may be held, reissued, resold or, at the option of the Issuer and the relevant purchaser, surrendered for cancellation to the Principal Paying Agent.

8.12 Cancellations

All Notes redeemed or substituted by the Issuer pursuant to this Condition 8, and all Notes purchased and surrendered for cancellation pursuant to Condition 8.11, will forthwith be cancelled. Any Notes so surrendered for cancellation may not be reissued or resold and the obligations of the Issuer and the Guarantor in respect of any such Notes shall be discharged.

8.13 Notices Final

Upon the expiry of any notice of redemption as is referred to in Conditions 8.5, 8.6 or 8.7 above the Issuer shall be bound to redeem the Notes to which the notice refers in accordance with the terms of the relevant Condition.

9. TAXATION

9.1 Payment without withholding

All payments in respect of the Notes by or on behalf of the Issuer or the Guarantor shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature ("**Taxes**") imposed or levied (a) by or on behalf of the Relevant Jurisdiction or (b) pursuant to an agreement described in Section 1471(b) of the U.S. Internal Revenue Code of 1986 (the "**Code**") or otherwise imposed pursuant to Sections 1471 through 1474 of the Code and any regulations or agreements thereunder, official interpretations thereof, or any law implementing an intergovernmental approach thereto ("**FATCA**"), in each case unless the withholding or deduction of the Taxes is required by law (including pursuant to an agreement described in Section 1471(b) of the Code or otherwise imposed pursuant to FATCA). In any such event, the Issuer or, as the case may be, the Guarantor will pay such additional amounts as may be necessary in order that the net amounts received by the Noteholders after the withholding or deduction shall equal the respective amounts which would have been received in respect of the Notes in the absence of the withholding or deduction; except that no additional amounts shall be payable in relation to any payment in respect of any Note:

(a) the holder of which is liable to the Taxes in respect of the Note by reason of his having some connection with the Relevant Jurisdiction other than the mere holding of the Note; or

(b) surrendered for payment (where surrender is required) in the United Kingdom; or

(c) in circumstances where such withholding or deduction would not be required if the holder or any person acting on his behalf had obtained and/or presented any form or certificate or had made a declaration of non-residence or similar claim for exemption to the relevant tax authority upon the making of which the holder would have been able to avoid such withholding or deduction; or

(d) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; or

(e) where such withholding or deduction is required by reason of an agreement described in Section 1471(b) of the Code or otherwise required by FATCA; or

(f) surrendered for payment (where surrender is required) by or on behalf of a holder who would have been able to avoid such withholding or deduction by surrendering the relevant Note to another Paying Agent in a Member State of the European Union; or

(g) surrendered for payment (where surrender is required) more than 30 days after the Relevant Date except to the extent that a holder would have been entitled to additional amounts on surrendering the same for payment on the last day of the period of 30 days assuming (whether or not such is in fact the case) that day to have been a Business Day.

9.2 Additional Amounts

Any reference in these Conditions to any amounts payable in respect of the Notes shall be deemed also to refer to any additional amounts which may be payable under this Condition or under any undertakings given in addition to, or in substitution for, this Condition pursuant to the Trust Deed.

10. PRESCRIPTION

Claims in respect of principal and interest will become prescribed unless made within 10 years (in the case of principal) and five years (in the case of interest) from the Relevant Date.

11. EVENTS OF DEFAULT

11.1 Rights to institute and/or prove in a winding-up of the Issuer

The right to institute winding-up proceedings in respect of the Issuer is limited to circumstances where a relevant payment by the Issuer under the Notes or the Trust Deed has become due and is not duly paid. For the avoidance of doubt, no amount shall be due from the Issuer in circumstances where payment of such amount could not be made in compliance with the Issuer Solvency Condition or is deferred by the Issuer in accordance with Conditions 6.1, 6.2, or 8.2.

If:

(a) default is made by the Issuer for a period of 7 days or more in the payment of any interest or principal due in respect of the Notes or any of them; or

(b) an Issuer Winding-Up occurs,

the Trustee at its discretion may, and if so requested by Noteholders of at least one-fifth in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution shall (but in each case subject to it having been indemnified and/or secured and/or prefunded to its satisfaction):

(i) in the case of (a) above, institute proceedings for the winding-up of the Issuer in England and Wales (but not elsewhere) and prove in the winding-up; and/or

(ii) in the case of (b) above, prove in the winding-up or administration of the Issuer (whether in England and Wales or elsewhere) and/or claim in the liquidation of the Issuer (whether in England and Wales or elsewhere),

but (in either case) may take no further or other action to enforce, prove or claim for any payment by the Issuer in respect of the Notes or the Trust Deed. No payment in respect of the Notes or the Trust Deed may be made by the Issuer pursuant to this Condition 11.1, nor will the Trustee accept the same, otherwise than during or after a winding-up of the Issuer or after an administrator of the Issuer has given notice that it intends to declare and distribute a dividend, unless the Issuer has given prior written notice (with a copy to the Trustee) to, and received no objection from, the FSA which the Issuer shall confirm in writing to the Trustee.

11.2 Rights to institute and/or prove in a winding-up of the Guarantor

The right to institute winding-up proceedings in respect of the Guarantor is limited to circumstances where a relevant payment by the Guarantor under the Guarantee has become due and is not duly paid. For the avoidance of doubt, no amount shall be due from the Guarantor in circumstances where payment of such amount could not be made in compliance with the Guarantor Solvency Condition or is deferred by the Guarantor in accordance with Conditions 6.3, 6.4, or 8.3.

If:

(a) default is made by the Guarantor for a period of 7 days or more in the payment of any amount due under the Guarantee; or

(b) a Guarantor Winding-Up occurs,

the Trustee at its discretion may, and if so requested by Noteholders of at least one-fifth in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution shall (but in each case subject to it having been indemnified and/or secured and/or prefunded to its satisfaction):

(i) in the case of (a) above, institute proceedings for the winding-up of the Guarantor in England and Wales (but not elsewhere) and prove in the winding-up; and/or

(ii) in the case of (b) above, prove in the winding-up or administration of the Guarantor (whether in England and Wales or elsewhere) and/or claim in the liquidation of the Guarantor (whether in England and Wales or elsewhere),

but (in either case) may take no further or other action to enforce, prove or claim for any payment by the Guarantor in respect of the Notes or the Trust Deed (including the Guarantee). No payment in respect of the Notes or the Trust Deed (including under the Guarantee) may be made by the Guarantor pursuant to this Condition 11.2, nor will the Trustee accept the same, otherwise than during or after a winding-up of the Guarantor or after an administrator of the Guarantor has given notice that it intends to declare and distribute a dividend, unless the Guarantor has given prior written notice (with a copy to the Trustee) to, and received no objection from, the FSA which the Guarantor shall confirm in writing to the Trustee.

11.3 Amount payable on a winding-up or administration

(a) *Issuer Winding-Up*: Upon the occurrence of an Issuer Winding-Up (including, for the avoidance of doubt, a winding-up initiated pursuant to Condition 11.1(i)), the Trustee at its discretion may, and if so requested by Noteholders of at least one-fifth in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution shall (but in each case subject to it having been indemnified and/or secured and/or prefunded to its satisfaction), give notice to the Issuer that the Notes are, and they shall accordingly forthwith become, immediately due and payable at the amount equal to their principal amount together with any Arrears of Interest and any other accrued and unpaid interest. Claims against the Issuer in respect of such amounts will be subordinated in accordance with Condition 3.2. However, as regards the Guarantor's obligation to pay under the Guarantee upon the occurrence of an Issuer Winding-Up, Condition 4.5 shall apply.

(b) *Guarantor Winding-Up*: Upon the occurrence of a Guarantor Winding-Up (including, for the avoidance of doubt, a winding-up initiated pursuant to Condition 11.2(i)), there shall be due and payable by the Guarantor as debtor in respect of the Notes, the Trust Deed and the Guarantee an amount equal to the principal amount of the Notes together with any Arrears of Interest and any other accrued and unpaid interest and, accordingly, upon the occurrence of a Guarantor Winding-Up the Trustee at its discretion may, and if so requested by Noteholders of at least one-fifth in principal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution shall (but in each case subject to it having been indemnified and/or secured and/or prefunded to its satisfaction), prove in the winding-up or administration (as the case may be) for such amount, but the Notes shall not thereby become immediately due and repayable by the Issuer. Claims against the Guarantor in respect of such amounts will be subordinated in accordance with Condition 4.3.

In the event that any Guarantor Recovered Amount is paid to the Noteholders (or the Trustee on their behalf) in the Guarantor Winding-Up, such Guarantor Recovered Amount will reduce the amounts payable by the Issuer in respect of the Notes and the Trust Deed to the extent and in the manner provided in Condition 4.4.

(c) *Adjustment of claims following payment or recovery*: Any claim against the Issuer pursuant to Condition 11.3(a) for amounts in respect of principal, interest and/or Arrears of Interest shall be reduced if, and to the extent that, any amounts in respect of the same are first paid by or recovered from the Guarantor (including, without limitation, any Guarantor Recovered Amount following a Guarantor Winding-Up). Any claim against the Guarantor pursuant to Condition 11.3(b) for amounts in respect of principal, interest and/or Arrears of Interest shall be reduced if, and to the extent that, any amounts in respect of the same are first paid by or recovered from the Issuer (including, without limitation, any Issuer Recovered Amount following an Issuer Winding-Up).

11.4 Enforcement

Without prejudice to Conditions 11.1, 11.2 or 11.3, the Trustee may at its discretion and without further notice institute such proceedings against the Issuer or the Guarantor as it may think fit to enforce any term or condition binding on the Issuer or the Guarantor (as the case may be) under the Trust Deed or the Notes (other than any payment obligation of the Issuer or the Guarantor under or arising from the Notes or the Trust Deed (including the Guarantee), including any damages awarded for breach of any obligations thereunder) but in no event shall the Issuer or the Guarantor, by virtue of the institution of any such proceedings, be obliged to pay any sum or sums, in cash or otherwise, sooner than the same would otherwise have been payable by it. Nothing in this Condition 11.4 shall, however, prevent the Trustee:

(a) subject to Condition 11.1, instituting proceedings for the winding-up of the Issuer in England and Wales and/or proving in any winding-up or administration of the Issuer (whether in England and Wales or elsewhere) and/or claiming in any liquidation of the Issuer (whether in England and Wales or elsewhere) in respect of any payment obligation of the Issuer; and/or

(b) subject to Condition 11.2, instituting proceedings for the winding-up of the Guarantor in England and Wales and/or proving in any winding-up or administration of the Guarantor (whether in England and Wales or elsewhere) and/or claiming in any liquidation of the Guarantor (whether in England and Wales or elsewhere) in respect of any payment obligation of the Guarantor,

in each case where such payment obligation arises from the Notes or the Trust Deed (including the Guarantee) (including, without limitation, payment of any principal, interest or Arrears of Interest in respect of the Notes or any damages awarded for breach of any obligations under the Notes or the Trust Deed (including the Guarantee)).

11.5 Entitlement of Trustee

The Trustee shall not be bound to take any of the actions referred to in Condition 11.1, 11.2, 11.3 or 11.4 above against the Issuer or the Guarantor to enforce the terms of the Trust Deed, the Notes or any other action under or pursuant to the Trust Deed unless (i) it shall have been so directed by an Extraordinary Resolution of the Noteholders or requested in writing by the holders of at least one-fifth in principal amount of the Notes then outstanding and (ii) it shall have been indemnified and/or secured and/or prefunded to its satisfaction.

11.6 Right of Noteholders

No Noteholder shall be entitled to proceed directly against the Issuer or the Guarantor or to institute proceedings for the winding-up or claim in the liquidation of the Issuer or the Guarantor or to prove in such winding-up unless the Trustee, having become so bound to proceed or being able to prove in such winding-up or claim in such liquidation, fails to do so within a reasonable period and such failure shall be continuing, in which case the Noteholder shall have only such rights against the Issuer or the Guarantor (as the case may be) as those which the Trustee is entitled to exercise as set out in this Condition 11.

11.7 Extent of Noteholders' remedy

No remedy against the Issuer or the Guarantor, other than as referred to in this Condition 11, shall be available to the Trustee or the Noteholders, whether for the recovery of amounts owing in respect of the Notes or under the Trust Deed or in respect of any breach by the Issuer or the Guarantor of any of its other obligations under or in respect of the Notes or under the Trust Deed.

12. REPLACEMENT OF CERTIFICATES

If any Certificate is lost, stolen, mutilated, defaced or destroyed it may be replaced at the specified office of the Registrar upon payment by the claimant of the expenses incurred in connection with the replacement and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Certificates must be surrendered before replacements will be issued.

13. NOTICES

All notices to the Noteholders will be valid if mailed to them at their respective addresses in the Register maintained by the Registrar. The Issuer shall also ensure that notices are duly given or published in a manner which complies with the rules and regulations of any stock exchange or other relevant authority on which the Notes are for the time being listed. Any notice shall be deemed to have been given on the second day after being so mailed or on the date of publication or, if so published more than once or on different dates, on the date of the first publication.

14. SUBSTITUTION OF ISSUER OR GUARANTOR

Subject to the Issuer giving at least one month's notice to, and receiving no objection from, the FSA (or such shorter period of notice as the FSA may accept and so long as there is a requirement to give such notice), the Trustee may agree with the Issuer and the Guarantor, without the consent of the Noteholders:

(a) to the substitution of the Guarantor in place of the Issuer as principal debtor under the Trust Deed and the Notes; or

(b) subject to the Notes remaining unconditionally and irrevocably guaranteed on a subordinated basis, in accordance with Condition 4, by the Guarantor, to the substitution of a Subsidiary or parent company of the Issuer or the Guarantor in place of the Issuer as principal debtor under the Trust Deed and the Notes; or

(c) to the substitution of (A) a successor in business (as defined in the Trust Deed) to the Guarantor or (B) a Subsidiary of the Guarantor, in each case in place of the Guarantor,

(each such substitute being hereinafter referred to as the "**Substitute Obligor**") provided that in each case:

(A) a trust deed or some other form of undertaking, supported by one or more legal opinions, is executed by the Substitute Obligor in a form and manner satisfactory to the Trustee, agreeing to be bound by the terms of the Trust Deed and the Notes, with any consequential amendments which the Trustee may deem appropriate, as fully as if the Substitute Obligor has been named in the Trust Deed and the Notes, as the principal debtor in place of the Issuer or (as the case may be) as the guarantor in place of the Guarantor (or of any previous Substitute Obligor, as the case may be);

(B) the Substitute Obligor certifies to the Trustee that (i) it has obtained all necessary governmental and regulatory approvals and consents necessary for its assumptions of the duties and liabilities as Substitute Obligor under the Trust Deed and the Notes in place of the Issuer or the Guarantor (as applicable) or, as the case may be, any previous Substitute Obligor and (ii) such approvals and consents are at the time of substitution in full force and effect (it being declared that the Trustee may rely absolutely on such certification without liability to any person);

(C) two directors (or other officers acceptable to the Trustee) of the Substitute Obligor certify that the Substitute Obligor is solvent at the time at which the substitution is proposed to be in effect, and immediately thereafter (it being declared that the Trustee may rely absolutely on such certification and shall not be bound to have regard to the financial condition, profits or prospects of the Substitute Obligor or to compare the same with those of the Issuer or (as the case may be) the Guarantor or (as the case may be) any previous Substitute Obligor);

(D) (without prejudice to the generality of the foregoing) the Trustee may, in the event of such substitution agree, without the consent of the Noteholders, to a change in the law governing the Trust Deed and/or the Notes if in the opinion of the Trustee such change would not be materially prejudicial to the interests of the Noteholders;

(E) if the Substitute Obligor is, or becomes, subject generally to the taxing jurisdiction of a territory or any authority of or in that territory with power to tax (the "**Substituted Territory**") other than the territory of the taxing jurisdiction of which (or to any such authority of or in which) the Issuer or (as the case may be) the Guarantor (or any previous Substitute Obligor) is subject generally (the "**Original Territory**"), the Substitute Obligor will (unless the Trustee otherwise agrees) give to the Trustee an undertaking satisfactory to the Trustee in terms corresponding to Condition 9 with the substitution for the references in that Condition and in Condition 8.6 to the Original Territory of references to the Substituted Territory whereupon the Trust Deed and the Notes will be read accordingly;

(F) the Issuer, the Guarantor and the Substitute Obligor comply with such other requirements as the Trustee may direct in the interests of the Noteholders;

(G) in the case of a substitution of the Guarantor pursuant to Condition 14(c)(B) only, if the Notes are rated (where such rating was assigned at the request of the Issuer) by one or more credit rating agencies of international standing immediately prior to such substitution, the Notes shall continue to be rated by each such rating agency immediately following such substitution, and the credit ratings assigned to the Notes by each such rating agency immediately following such substitution are expected to be no less than those assigned to the Notes immediately prior thereto; and

(H) without prejudice to the rights of reliance of the Trustee under (B) and (C) above, the Trustee shall be satisfied that the interests of the Noteholders will not be materially prejudiced by any substitution proposed pursuant to this Condition 14.

15. MEETINGS OF NOTEHOLDERS, MODIFICATION, WAIVER AND AUTHORISATION

15.1 Meetings of Noteholders

Except as provided herein, any modification to these Conditions or any provisions of the Trust Deed will require the Issuer giving at least one month's prior written notice to, and receiving no objection from, the FSA (or such shorter period of notice as the FSA may accept and so long as there is a requirement to give such notice).

The Trust Deed contains provisions for convening meetings of the Noteholders to consider any matter affecting their interests, including the modification or abrogation by Extraordinary Resolution of any of these Conditions or any of the provisions of the Trust Deed. Such a meeting may be convened by the Issuer, the Guarantor, the Trustee or Noteholders holding not less than 10 per cent. in principal amount of the Notes for the time being outstanding. The quorum at any meeting for passing an Extraordinary Resolution will be one or more persons present holding or representing more than 50 per cent. in principal amount of the Notes for the time being outstanding, or at any adjourned such meeting one or more persons present whatever the principal amount of the Notes held or represented by him or them, except that, at any meeting the business of which includes the modification or abrogation of certain of the provisions of these Conditions and certain of the provisions of the Trust Deed, the necessary quorum for passing an Extraordinary Resolution will be one or more persons present holding or representing not less than two-thirds, or at any adjourned such meeting not less than one-third, of the principal amount of the Notes for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Noteholders will be binding on all Noteholders, whether or not they are present at the meeting.

The Trust Deed also provides that a written resolution executed by or on behalf of the holders of 100 per cent. in principal amount of the Notes outstanding who would have been entitled to vote upon it if it had been proposed at a meeting at which they were present shall take effect as if it were an Extraordinary Resolution.

The agreement or approval of the Noteholders shall not be required in the case of any variation of these Conditions and/or the Trust Deed required to be made in connection with the substitution or variation of the Notes pursuant to Conditions 8.6 or 8.7 or any consequential amendments to these Conditions and/or the Trust Deed approved by the Trustee in connection with a substitution of the Issuer or the Guarantor pursuant to Condition 14.

15.2 Modification, waiver, authorisation and determination

The Trustee may agree, without the consent of the Noteholders, to any modification of, or to the waiver or authorisation of any breach or proposed breach of, any of these Conditions or any of the provisions of the Trust Deed (provided that, in any such case, it is not, in the opinion of the Trustee, materially prejudicial to the interests of the Noteholders) or may agree, without any such consent as aforesaid, to any modification which, in its opinion, is of a formal, minor or technical nature or to correct a manifest error or to comply with mandatory provisions of the law of the jurisdiction in which the Issuer or the Guarantor is incorporated.

15.3 Trustee to have regard to interests of Noteholders as a class

In connection with the exercise by it of any of its trusts, powers, authorities and discretions (including, without limitation, any modification, waiver, authorisation, determination or substitution of obligor), the Trustee shall have regard to the general interests of the Noteholders as a class but shall not have regard to any interests arising from circumstances particular to individual Noteholders (whatever their number) and, in particular but without limitation, shall not have regard to the consequences of any such exercise for individual Noteholders (whatever their number) resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any particular territory or any political sub-division thereof and the Trustee shall not be entitled to require, nor shall any Noteholder be entitled to claim, from the Issuer, the Guarantor, the Trustee or any other person any indemnification or payment in respect of any tax consequence of any such exercise upon individual Noteholders except to the extent already provided for in Condition 9 and/or any undertaking given in addition to, or in substitution for, Condition 9 pursuant to the Trust Deed.

15.4 Notification to the Noteholders

Any modification, abrogation, waiver, authorisation, determination or substitution shall be binding on the Noteholders and, unless the Trustee agrees otherwise, shall be notified by the Issuer to the Noteholders as soon as practicable thereafter in accordance with Condition 13.

16. TRANSFER OF BUSINESS OF THE GUARANTOR

The Guarantor may transfer the whole or a substantial part of its business (including its obligations under the Guarantee) without any prior approval from the Trustee or the Noteholders:

(a) to another body in accordance with Part VII of the FSMA (a "**Successor**"). If the Guarantor transfers all or a substantial part of its business to a Successor in accordance herewith, the Guarantor shall procure that there be included in the assets and liabilities to be transferred to such Successor all the liabilities and obligations of the Guarantor as principal obligor under the Guarantee and references in these Conditions and the Trust Deed to the Guarantor shall be construed accordingly; and

(b) to a single legal entity where such transfer is pursuant to the exercise by the FSA or the Financial Services Compensation Scheme of its powers in connection with any applicable law, rule or regulation. If the Guarantor is required to make such a transfer, the Guarantor shall procure that there be included in the transfer all the liabilities and obligations of the Guarantor as principal obligor under the Guarantee and references in these Conditions and the Trust Deed to the Guarantor shall be construed accordingly.

In this Condition 16, "**a substantial part**" means any part which, as at the most recent valuation date by reference to the latest published financial statements of the Guarantor and as certified in writing by two Directors of the Guarantor to the Trustee, represents 50 per cent. or more of liabilities (where the amount of the liabilities of the Guarantor is deemed to mean the same as the technical provisions of the Guarantor, net of reinsurance) relating to policies underwritten by the Guarantor.

17. INDEMNIFICATION OF THE TRUSTEE AND ITS CONTRACTING WITH THE ISSUER AND THE GUARANTOR

17.1 Indemnification of the Trustee

The Trust Deed contains provisions for the indemnification of the Trustee and for its relief from responsibility, including provisions relieving it from taking action unless indemnified and/or secured and/or prefunded to its satisfaction.

17.2 Trustee contracting with the Issuer and the Guarantor

The Trust Deed also contains provisions pursuant to which the Trustee is entitled, *inter alia*, (i) to enter into business transactions with the Issuer and/or the Guarantor and/or any of the Issuer's other Subsidiaries and to act as trustee for the holders of any other securities issued or guaranteed by, or relating to, the Issuer and/or the Guarantor and/or any of the Issuer's other Subsidiaries, (ii) to exercise and enforce its rights, comply with its obligations and perform its duties under or in relation to any such transactions or, as the case may be, any such trusteeship without regard to the interests of, or consequences for, the Noteholders, and (iii) to retain and not be liable to account for any profit made or any other amount or benefit received thereby or in connection therewith.

18. FURTHER ISSUES

The Issuer may from time to time, without the consent of the Noteholders, create and issue further notes ranking *pari passu* in all respects (or in all respects save for the first payment of interest thereon) and so that the same shall be consolidated and form a single series with the outstanding Notes. Any further notes which are to form a single series with the outstanding Notes may (with the consent of the Trustee) be constituted by a deed supplemental to the Trust Deed.

19. GOVERNING LAW

The Trust Deed (including the Guarantee) and the Notes, and any non-contractual obligations arising out of or in connection with the Trust Deed (including the Guarantee) and/or the Notes are governed by, and shall be construed in accordance with, English law.

20. RIGHTS OF THIRD PARTIES

No rights are conferred on any person under the Contracts (Rights of Third Parties) Act 1999 to enforce any term or condition of the Notes, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

21. DEFINED TERMS

In these Conditions:

"**Agency Agreement**" has the meaning given in the preamble to these Conditions;

"**Agents**" means the Registrar, the Principal Paying Agent and the other Paying Agents appointed from time to time under the Agency Agreement;

"**Arrears of Interest**" has the meaning given in Condition 6.6;

"**Assets**" means the unconsolidated gross assets of the Issuer or the Guarantor (as the case may be) as shown in the latest published audited balance sheet of the Issuer or the Guarantor (as the case may be), but adjusted for subsequent events, all in such manner as the Directors may determine;

"**Business Day**" means (i) except for the purposes of Condition 2, 7.4 and 9.1(g), a day (other than a Saturday, Sunday or public holiday) on which commercial banks and foreign exchange markets are open for general business in London, (ii) for the purposes of Condition 2, a day (other than a Saturday, Sunday or public holiday) on which commercial banks are open for business in the city in which the specified office of the Agent with whom a Certificate is deposited in connection with a transfer is located and (iii) for the purpose of Condition 7.4 and 9.1(g), a day (other than a Saturday, Sunday or public holiday) on which commercial banks are open for business in London and, in the case of surrender of a Certificate, in the place in which the Certificate is surrendered;

"**Capital Disqualification Event**" is deemed to have occurred if, as a result of any replacement of or change to (or change to the interpretation by any court or authority entitled to do so of) Solvency II or the Relevant Rules or following the implementation of Solvency II:

(a) the Notes are no longer capable of counting; or

(b) in the circumstances where such capability derives only from transitional or grandfathering provisions under Solvency II or the Relevant Rules, as appropriate, less than 100 per cent. of the principal amount of either (a) the Notes outstanding at such time or (b) any indebtedness outstanding at such time and classified in the same category as the Notes by the Insurance Group Supervisor for the purposes of any transitional or grandfathering provisions under Solvency II or the Relevant Rules, as appropriate, is capable of counting,

as:

(x) cover for capital requirements or treated as own funds (however such terms might be described in Solvency II or the Relevant Rules) applicable to the Issuer, the Insurance Group or any insurance or reinsurance undertaking within the Insurance Group whether on a solo, group or consolidated basis, or

(y) Tier 2 Capital for the purposes of the Issuer, the Insurance Group, or any insurance or reinsurance undertaking within the Insurance Group whether on a solo, group or consolidated basis,

except where in the case of either (x) or (y) above such non-qualification is only as a result of any applicable limitation on the amount of such capital;

"**Certificate**" has the meaning given in Condition 1.1;

"**Companies Act**" means the Companies Act 2006 (as amended or re-enacted from time to time);

"**Compulsory Interest Payment Date**" means any Interest Payment Date (i) in respect of which during the period of six months ending on such Interest Payment Date a Compulsory Interest Payment Event has occurred, (ii) on which the Issuer Solvency Condition is satisfied and (iii) which is not a Mandatory Interest Deferral Date;

"**Compulsory Interest Payment Event**" means:

(a) any declaration, payment or making of a dividend or distribution by the Issuer to its ordinary shareholders; or

(b) any declaration, payment or making of a dividend, distribution or coupon on any other Junior Securities of the Issuer, except where such dividend, distribution or coupon was required to be declared, paid or made under the terms of such Junior Securities of the Issuer; or

(c) any declaration, payment or making of a dividend, distribution or coupon on any Pari Passu Securities of the Issuer, except where such dividend, distribution or coupon was required to be declared, paid or made under the terms of such Pari Passu Securities of the Issuer; or

(d) any repurchase by the Issuer of its ordinary shares for cash, provided such repurchase is not made in the ordinary course of business of the Issuer in connection with any share option scheme or share ownership scheme for management or employees of the Issuer or management or employees of affiliates of the Issuer; or

(e) any redemption or repurchase by the Issuer, the Guarantor or any other Subsidiary of the Issuer of any other Junior Securities of the Issuer for cash, except a redemption required to be effected under the terms of such Junior Securities of the Issuer; or

(f) any redemption or repurchase by the Issuer, the Guarantor or any other Subsidiary of the Issuer of any Pari Passu Securities of the Issuer for cash, except a redemption required to be effected under the terms of such Pari Passu Securities of the Issuer, provided that if at any time, and for so long as, the existence of any of the Compulsory Interest Payment Events at paragraphs (b), (c), (e) and/or (f) above would result in the Notes or any part thereof ceasing to be eligible to qualify as Lower Tier 2 Capital (or, following Solvency II Implementation, Tier 2 Capital) under Solvency II or the Relevant Rules, each of those paragraphs which would cause such result shall have no effect and the circumstances described therein shall not constitute a Compulsory Interest Payment Event;

"**Directors**" means the directors of the Issuer or, as the case may be, of the Guarantor;

"**Extraordinary Resolution**" has the meaning given in the Trust Deed;

"**Financial Services Authority**" or "**FSA**" means the Financial Services Authority or such successor or other authority having primary supervisory authority with respect to prudential matters in relation to the Issuer, the Guarantor and/or the Insurance Group;

"**Financial Services Compensation Scheme**" means the UK compensation scheme, established under the FSMA, which commenced operations on 1 December 2001 as a fund of last resort to protect deposits and certain other obligations, within prescribed limits, of customers of authorised financial services firms which are unable, or likely to become unable, to meet their obligations in respect thereof, or any successor or replacement scheme;

"**First Call Date**" means 27 April 2022;

"**Fixed Interest Rate**" has the meaning given in Condition 5.3;

"**Fixed Rate Interest Period**" mean the period from and including the Issue Date to but excluding the First Call Date;

"**Floating Interest Amount**" has the meaning given in Condition 5.5;

"**Floating Interest Rate**" has the meaning given in Condition 5.4;

"**FSMA**" means the Financial Services and Markets Act 2000 (as amended or re-enacted from time to time);

"**Guarantee**" has the meaning given in Condition 4.1;

"**Guaranteed Amounts**" has the meaning given in Condition 4.1;

"**Guarantor**" has the meaning given in the preamble to these Conditions;

"**Guarantor Interest Portion**" means, in respect of a Guarantor Recovered Amount, an amount equal to such Guarantor Recovered Amount multiplied by a fraction the numerator of which is the Total Guarantor Interest Amount and the denominator of which is the aggregate of the Total Guarantor Interest Amount and the principal amount of the Notes outstanding as at the date of the Guarantor Winding-up;

"**Guarantor Mandatory Interest Deferral Date**" means any date in respect of which a Guarantor Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment of any Guaranteed Amounts in respect of interest was made on such date;

"**Guarantor Non-Interest Portion**" means the Guarantor Recovered Amount less the Guarantor Interest Portion;

"**Guarantor Optional Interest Payment Date**" means any date which is not a Guarantor Mandatory Interest Deferral Date;

"**Guarantor Recovered Amount**" has the meaning given in Condition 4.4;

"**Guarantor Recovered Amount Payment Date**" means in respect of any Guarantor Recovered Amount, the date on which such Guarantor Recovered Amount is paid by the liquidator or administrator (as applicable) of the Guarantor to the Noteholders (or the Trustee on their behalf);

"**Guarantor Regulatory Deficiency Interest Deferral Event**" means any event which (including, without limitation, any event which causes the Solvency Capital Requirement applicable to the Guarantor, the Insurance Group or any member of the Insurance Group to be breached and such breach is an event which) under Solvency II and/or under the Relevant Rules would require the Guarantor (in its capacity as the Guarantor or if it were treated as issuer of the Notes) to defer payment of any Guaranteed Amounts in respect of interest (on the basis that the Notes are intended to qualify as Tier 2 Capital under Solvency II without the operation of any grandfathering provisions);

"**Guarantor Regulatory Deficiency Redemption Deferral Event**" means any event which (including, without limitation, any event which causes the Solvency Capital Requirement applicable to the Guarantor, the Insurance Group or any member of the Insurance Group to be breached and such breach is an event which) under Solvency II and/or under the Relevant Rules would require the Guarantor (in its capacity as the Guarantor or if it were treated as issuer of the Notes) to defer or suspend repayment or redemption of (or payment of any Guaranteed Amounts in respect of repayment or redemption of) the Notes (on the basis that the Notes are intended to qualify as Tier 2 Capital under Solvency II without the operation of any grandfathering provisions);

"**Guarantor Solvency Condition**" has the meaning given in Condition 4.6;

"**Guarantor Winding-Up**" has the meaning given in Condition 4.3;

"**Insurance Group**" means the Issuer, the Guarantor and the Issuer's other Subsidiaries;

"**Insurance Group Supervisor**" means the regulatory authority exercising group supervision over the Insurance Group in accordance with the Solvency II Directive;

"**Interest Determination Date**" means the first day of each Interest Period beginning on or after the First Call Date;

"**Interest Payment Date**" means 27 April and 27 October in each year, commencing 27 October 2012, provided that if after the First Call Date any such date is not a Business Day, the relevant Interest Payment Date will be postponed until the next Business Day unless it would thereby fall into the following month in which case such Interest Payment Date shall be brought forward to the immediately preceding Business Day;

"**Interest Period**" means the period from (and including) one Interest Payment Date (or in the case of the first Interest Period, from the Issue Date) to (but excluding) the next (or in the case of the first Interest Period, the first) Interest Payment Date;

"**Interest Rate**" means the Fixed Interest Rate or the Floating Interest Rate, as applicable;

"**Internal Loan**" means any loan made at any time to the Guarantor by the Issuer which constitutes, or would but for any applicable limitation on the amount of such capital constitute, Lower Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 2 Capital (issued on or after Solvency II Implementation) of the Guarantor out of the proceeds of an issue of any obligation (including the Notes) constituting, or but for any applicable limitation on the amount of such capital constituting, Lower Tier 2 Capital (issued prior to Solvency II Implementation) or Tier 2 Capital (issued on or after Solvency II Implementation) of the Issuer and guaranteed on a subordinated basis by the Guarantor;

"**Issue Date**" means 27 April 2012;

"**Issuer**" has the meaning given in the preamble to these Conditions;

"**Issuer Interest Portion**" means, in respect of an Issuer Recovered Amount, an amount equal to such Issuer Recovered Amount multiplied by a fraction the numerator of which is the Total Issuer Interest Amount and the denominator of which is the aggregate of the Total Issuer Interest Amount and the principal amount of the Notes outstanding as at the date of the Issuer Winding-Up;

"**Issuer Non-Interest Portion**" means the Issuer Recovered Amount less the Issuer Interest Portion;

"**Issuer Recovered Amount**" has the meaning given in Condition 3.3;

"**Issuer Recovered Amount Payment Date**" means, in respect of any Issuer Recovered Amount, the date on which such Issuer Recovered Amount is paid by the liquidator or administrator (as applicable) of the Issuer to the Noteholders (or the Trustee on their behalf);

"**Issuer Solvency Condition**" has the meaning given in Condition 3.4;

"**Issuer Winding-Up**" has the meaning given in Condition 3.2;

"**Junior Creditors of the Guarantor**" means creditors of the Guarantor whose claims rank, or are expressed to rank junior to, the claims of the Noteholders including holders of Junior Securities of the Guarantor;

"**Junior Creditors of the Issuer**" means creditors of the Issuer whose claims rank, or are expressed to rank junior to, the claims of the Noteholders including holders of Junior Securities of the Issuer;

"**Junior Securities of the Guarantor**" has the meaning given in Condition 4.3;

"**Junior Securities of the Issuer**" has the meaning given in Condition 3.2;

"**Liabilities**" means the unconsolidated gross liabilities of the Issuer or the Guarantor (as the case may be) as shown in the latest published audited balance sheet of the Issuer or the Guarantor (as the case may be), but adjusted for contingent liabilities and for subsequent events, all in such manner as the Directors may determine;

"**London Stock Exchange**" means the London Stock Exchange plc;

"**Lower Tier 2 Capital**" has the meaning given by the FSA from time to time and shall, following the implementation of Solvency II or any other change in law or any Relevant Rules such that Lower Tier 2 Capital ceases to be a recognised tier of capital resources, be deemed to be a reference to any Tier 2 Capital;

"**Mandatory Interest Deferral Date**" means each Interest Payment Date in respect of which a Regulatory Deficiency Interest Deferral Event has occurred and is continuing or would occur if payment of interest was made on such Interest Payment Date;

"**Margin**" means 7.910 per cent. per annum;

"**Maturity Date**" means the Interest Payment Date falling on or around 27 April 2042;

"**Member State**" means a member of the European Economic Area;

"**Noteholder**" has the meaning given in Condition 1.2;

"**Notes**" has the meaning given in the preamble to these Conditions;

Official List" means the official list of the UK Listing Authority;

"**Optional Interest Payment Date**" means any Interest Payment Date other than a Compulsory Interest Payment Date or a Mandatory Interest Deferral Date;

"**Original Territory**" has the meaning given in Condition 14;

"**Pari Passu Creditors of the Guarantor**" means creditors of the Guarantor whose claims rank, or are expressed to rank, *pari passu* with the claims of the Noteholders including holders of Pari Passu Securities of the Guarantor;

"**Pari Passu Creditors of the Issuer**" means creditors of the Issuer whose claims rank, or are expressed to rank, *pari passu* with the claims of the Noteholders including holders of Pari Passu Securities of the Issuer;

"**Pari Passu Securities of the Guarantor**" has the meaning given in Condition 4.3;

"**Pari Passu Securities of the Issuer**" has the meaning given in Condition 3.2;

"**Paying Agents**" means the Principal Paying Agent and the Registrar (and such term shall include any successor, replacement or additional paying agents appointed under the Agency Agreement);

"**Principal Paying Agent**" has the meaning given in the preamble to these Conditions;

"**Qualifying Dated Tier 2 Securities**" means securities issued directly or indirectly by the Issuer that:

(a) have terms not materially less favourable to an investor than the terms of the Notes (as reasonably determined by the Issuer in consultation with an independent investment bank of international standing, and provided that a certification to such effect (including as to the consultation with the independent investment bank and in respect of the matters specified in (1) to (7) below) signed by two Directors shall have been delivered to the Trustee (upon which the Trustee shall be entitled to rely without liability to any person) prior to the issue of the relevant securities) provided that they shall (1) contain terms which comply with then current requirements of the FSA in relation to Tier 2 Capital (or, at any time prior to Solvency II Implementation, Lower Tier 2 Capital); (2) bear at least the same rate of interest from time to time applying to the Notes and preserve the Interest Payment Dates; (3) contain terms providing for mandatory deferral of payments of interest and/or principal only if such terms are not materially less favourable to an investor than the mandatory deferral provisions contained in the terms of the Notes; (4) rank senior to, or *pari passu* with, the Notes; (5) preserve the obligations (including the obligations arising from the exercise of any right) of the Issuer and the Guarantor as to redemption of the Notes, including (without limitation) as to timing of, and amounts payable upon, such redemption; (6) not contain terms providing for loss absorption through principal write-down or conversion to ordinary shares; (7) preserve any existing rights under these Conditions to any accrued interest, any Arrears of Interest and any other amounts payable under the Notes which, in each case, has accrued to Noteholders and not been paid; and (8) benefit from a guarantee from the Guarantor subordinated on the same basis and to the same extent as the Guarantee; and

(b) are listed or admitted to trading on the London Stock Exchange's regulated market (for the purposes of Directive 2004/39/EC) or such other stock exchange as is a Recognised Stock Exchange at that time as selected by the Issuer and approved by the Trustee;

"**Rating Agency**" means Standard & Poor's Credit Market Services Europe Limited or any successor thereof;

"**Rating Agency Compliant Securities**" means securities issued directly or indirectly by the Issuer that are:

(a) Qualifying Dated Tier 2 Securities; and

(b) assigned substantially the same equity content or, at the absolute discretion of the Issuer, a lower equity content (provided such equity content is still higher than the equity content assigned to the Notes after the occurrence of the Ratings Methodology Event) as that which was assigned by the Rating Agency to the Notes on or around the Issue Date and provided that a certification to such effect of two Directors shall have been delivered to the Trustee prior to the issue of the relevant securities (upon which the Trustee shall be entitled to rely without liability to any person);

"**Ratings Methodology Event**" will be deemed to occur upon a change in methodology of the Rating Agency (or in the interpretation of such methodology) as a result of which the equity content assigned by the Rating Agency to the Notes is, as notified by the Rating Agency to the Issuer or as published by the Rating Agency, reduced when compared to the equity content assigned by the Rating Agency to the Notes on or around the Issue Date;

"**Recognised Stock Exchange**" means a recognised stock exchange as defined in section 1005 of the Income Tax Act 2007 as amended or re-enacted from time to time, and any provision, statute or statutory instrument replacing the same from time to time;

"**Reference Banks**" means four major international banks selected by the Principal Paying Agent active in the sterling interbank market in London;

"**Register**" has the meaning given in Condition 1.1;

"**Registrar**" has the meaning given in the preamble to these Conditions;

"**Regulatory Capital Requirements**" means any applicable capital resources requirement or applicable overall financial adequacy rule required by the FSA, as such requirements or rule are in force from time to time;

"**Regulatory Clearance Condition**" means, in respect of any proposed act on the part of the Issuer or the Guarantor, the FSA having consented to, or having been given due notification of and having not within any applicable time-frame objected to, such act (in any case only if and to the extent required by the FSA or any applicable rules of the FSA at the relevant time);

"**Regulatory Deficiency Interest Deferral Event**" means any event which (including, without limitation, any event which causes the Solvency Capital Requirement applicable to the Issuer, the Insurance Group or any member of the Insurance Group to be breached and such breach is an event which) under Solvency II and/or under the Relevant Rules would require the Issuer to defer payment of interest in respect of the Notes (on the basis that the Notes are intended to qualify as Tier 2 Capital under Solvency II without the operation of any grandfathering provisions);

"**Regulatory Deficiency Redemption Deferral Event**" means any event which (including, without limitation, any event which causes the Solvency Capital Requirement applicable to the Issuer, the Insurance Group or any member of the Insurance Group to be breached and such breach is an event which) under Solvency II and/or under the Relevant Rules would require the Issuer to defer or suspend repayment or redemption of the Notes (on the basis that the Notes are intended to qualify as Tier 2 Capital under Solvency II without the operation of any grandfathering provisions);

"**Relevant Date**" means the date on which the payment first becomes due but, if the full amount of the money payable has not been received by an Agent or the Trustee on or before the due date, it means the date on which, the full amount of the money having been so received, notice to that effect has been duly given to the Noteholders by the Issuer in accordance with Condition 13;

"**Relevant Jurisdiction**" means the United Kingdom or any political subdivision or any authority thereof or therein having power to tax or any other jurisdiction or any political subdivision or any authority thereof or therein having power to tax to which the Issuer or the Guarantor, as the case may be, becomes subject in respect of payments made by it of principal and interest (including Arrears of Interest) on the Notes or any Guaranteed Amounts in respect thereof;

"**Relevant Rules**" means any legislation, rules or regulations (whether having the force of law or otherwise) applying to the Guarantor or any insurance or reinsurance undertaking within the Insurance Group from time to time relating to the characteristics, features or criteria of own funds or capital resources and, for the avoidance of doubt and without limitation to the foregoing, includes any legislation, rules or regulations relating to such matters which are supplementary or extraneous to the obligations imposed on Member States by Solvency I or the Solvency II Directive;

"**Senior Creditors of the Guarantor**" means (a) any policyholders of the Guarantor (and, for the avoidance of doubt, the claims of Senior Creditors of the Guarantor who are policyholders shall include all amounts to which they would be entitled under applicable legislation or rules relating to the winding-up of insurance companies to reflect any right to receive, or expectation of receiving, benefits which policyholders may have); (b) creditors of the Guarantor (other than policyholders) who are unsubordinated creditors of the Guarantor; (c) other creditors of the Guarantor whose claims are, or are expressed to be, subordinated to the claims of other creditors of the Guarantor (other than those whose claims constitute (or relate to a guarantee or other like or similar undertaking or arrangement given by the Guarantor in respect of any obligation of any other person which constitute), or would but for any applicable limitation on the amount of any such capital constitute, Tier 1 Capital, Upper Tier 2 Capital (issued prior to Solvency II Implementation), Lower Tier 2 Capital (issued prior to Solvency II Implementation), or Tier 2 Capital (issued on or after Solvency II Implementation) or whose claims otherwise rank, or are expressed to rank, *pari passu* with, or junior to, the claims of the Noteholders); and (d) the Issuer in its capacity as a creditor of the Guarantor in respect of any Internal Loan;

"**Senior Creditors of the Issuer**" means (a) creditors of the Issuer who are unsubordinated creditors of the Issuer and (b) other creditors of the Issuer whose claims are, or are expressed to be, subordinated to the claims of other creditors of the Issuer (other than those whose claims constitute (or relate to a guarantee or other like or similar undertaking or arrangement given by the Issuer in respect of any obligation of any other person which constitute), or would but for any applicable limitation on the amount of any such capital, constitute Tier 1 Capital, Upper Tier 2 Capital (issued prior to Solvency II Implementation), Lower Tier 2 Capital (issued prior to Solvency II Implementation), or Tier 2 Capital (issued on or after Solvency II Implementation) or whose claims otherwise rank, or are expressed to rank, *pari passu* with, or junior to, the claims of the Noteholders);

"**Solvency I**" means the directives adopted by the Parliament and Council of the European Union relating to the taking-up and pursuit of insurance business within the European Union (excluding the Solvency II Directive) and including, without limitation, Directive 73/239/EEC of the European Union (as amended) and Directive 98/78/EC of the European Union (as amended) on the supplementary supervision of insurance undertakings in an insurance group;

"**Solvency II**" means the Solvency II Directive and any implementing measures adopted pursuant to the Solvency II Directive (for the avoidance of doubt, whether implemented by way of regulation or by further directives or otherwise);

"**Solvency II Directive**" means Directive 2009/138/EC of the European Union (as amended) on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) and which must be transposed by Member States pursuant to Article 309 of Directive 2009/138/EC;

"**Solvency II Implementation**" means the implementation by the FSA of Solvency II or any other change in law or any Relevant Rules (or, if later, the coming into effect of the same with respect to the Issuer, the Guarantor and/or the Insurance Group);

"**Solvency Capital Requirement**" means the Solvency Capital Requirement or the group Solvency Capital Requirement referred to in, or any other capital requirement howsoever described in, Solvency II or the Relevant Rules;

"**sterling**" or "**pence**" or "**£**" means the lawful currency of the United Kingdom;

"**Subsidiary**" has the meaning given under section 1159 of the Companies Act;

"**Substitute Obligor**" has the meaning given in Condition 14;

"**Substituted Territory**" has the meaning given in Condition 14;

"**Successor**" has the meaning given in Condition 16;

"**successor in business**" has the meaning, with respect to the Issuer or the Guarantor (as the case may be), given in the Trust Deed;

"**Taxes**" has the meaning given in Condition 9;

"**Tier 1 Capital**" has the meaning given by the FSA from time to time;

"**Tier 2 Capital**" has the meaning given by the FSA from time to time;

"**Total Guarantor Interest Amount**" means the aggregate of (i) interest accrued (but unpaid) on the Notes from the last Interest Payment Date preceding the Guarantor Winding-Up to the date of the Guarantor Winding-Up and (ii) Arrears of Interest;

"**Total Issuer Interest Amount**" means the aggregate of (i) interest accrued (but unpaid) on the Notes from the last Interest Payment Date preceding the Issuer Winding-Up to the date of the Issuer Winding-Up and (ii) Arrears of Interest;

"**Trust Deed**" has the meaning given in the preamble to these Conditions;

"**Trustee**" has the meaning given in the preamble to these Conditions;

"**UK Listing Authority**" means the Financial Services Authority in its capacity as competent authority under the Financial Services and Markets Act 2000; and

"**Upper Tier 2 Capital**" has the meaning given by the FSA from time to time.

THE GLOBAL CERTIFICATE

The following provisions apply to the Notes whilst they are represented by the Global Certificate, some of which modify the effect of the Conditions.

1. Accountholders

For so long as all of the Notes are represented by the Global Certificate and such Global Certificate is held on behalf of a clearing system, each person (other than another clearing system) who is for the time being shown in the records of Euroclear Bank S.A./N.V. ("**Euroclear**") or Clearstream Banking, *société anonyme* ("**Clearstream, Luxembourg**") (as the case may be) as the holder of a particular aggregate principal amount of such Notes (each an "**Accountholder**") (in which regard any certificate or other document issued by Euroclear or Clearstream, Luxembourg (as the case may be) as to the aggregate principal amount of such Notes standing to the account of any person shall, in the absence of manifest error, be conclusive and binding for all purposes) shall be treated as the holder of such aggregate principal amount of such Notes (and the expression "Noteholders" and references to "holding of Notes" and to "holder of Notes" shall be construed accordingly) for all purposes other than with respect to payments on such Notes, the right to which shall be vested, as against the Issuer, the Guarantor and the Trustee, solely in the nominee of a common depositary for the relevant clearing system (the "**Relevant Nominee**") in accordance with and subject to the terms of the Global Certificate. Each Accountholder must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for its share of each payment made to the Relevant Nominee.

2. Cancellation

Cancellation of any Note following its redemption or purchase by the Issuer, the Guarantor or any of the Issuer's other Subsidiaries will be effected by reduction in the aggregate principal amount of the Notes in the register of Noteholders.

3. Payments

Payments of principal and interest in respect of Notes represented by the Global Certificate will be made to the registered holder of the Global Certificate, provided that if no further payment falls to be made in respect of the Notes, payment will only be made against surrender of the Global Certificate to, or to the order of, the Registrar or such other Agent as shall have been notified to the holder of the Global Certificate for such purpose.

Distributions of amounts with respect to book-entry interests in the Notes held through Euroclear or Clearstream, Luxembourg will be credited, to the extent received by the Registrar, to the cash accounts of Euroclear or Clearstream, Luxembourg participants in accordance with the relevant clearing system's rules and procedures.

All payments in respect of the Notes whilst they are represented by the Global Certificate will be made to, or to the order of, the person whose name is entered on the Register at the close of business on the Clearing System Business Day immediately prior to the date for payment, where "**Clearing System Business Day**" means Monday to Friday (inclusive) except 25 December and 1 January.

4. Notices

So long as all the Notes are represented by the Global Certificate and it is held on behalf of a clearing system, notices to Noteholders may be given by delivery of the relevant notice to that clearing system for communication by it to entitled Accountholders in substitution for notification as required by the Conditions.

Whilst any of the Notes held by a Noteholder are represented by the Global Certificate, notices to be given by such Noteholder may be given by such Noteholder (where applicable) through Euroclear and/or Clearstream, Luxembourg and otherwise in such manner as the Trustee and Euroclear and Clearstream, Luxembourg may approve for this purpose.

5. Transfers and Exchange

The following will apply in respect of transfers of the Notes held in Euroclear or Clearstream, Luxembourg or another clearing system. These provisions will not prevent the trading of interests in the

Notes within a clearing system whilst they are held on behalf of such clearing system, but will limit the circumstances in which the Notes may be withdrawn from the relevant clearing system.

Transfers of the holding of Notes represented by the Global Certificate pursuant to Condition 2 may only be made in part:

(i) if the relevant clearing system is closed for business for a continuous period of 14 days (other than by reason of holidays, statutory or otherwise) or announces an intention permanently to cease business or does in fact do so; or

(ii) upon or following any failure to pay principal in respect of any Notes when it is due and payable; or

(iii) with the consent of the Issuer,

provided that, in the case of the first transfer of part of a holding pursuant to paragraph (i) or (ii) above, the Relevant Nominee has given the Registrar not less than 30 days' notice at its specified office of the Relevant Nominee's intention to effect such transfer.

6. Trustee's Powers

In considering the interests of Noteholders while the Global Certificate is held on behalf of, or registered in the name of the Relevant Nominee, the Trustee may have regard to any information provided to it by such clearing system or its operator as to the identity (either individually or by category) of its accountholders with entitlements to the Global Certificate and may consider such interests as if such accountholders were the holders of the Notes represented by the Global Certificate.

USE OF PROCEEDS

The net proceeds of the issue of the Notes will be lent by the Issuer to the Guarantor by way of an intra-group loan which is intended to qualify as tier 2 capital of the Guarantor on a solo basis.

The Guarantor will apply such amounts to the repayment by the Group of approximately £248 million of intra-group debt owed to the RBS Group. The net proceeds will also provide the Group with qualifying regulatory capital, enabling the Issuer to pay dividends in the range of £500 million to £1 billion to the RBS Group prior to divestment, of which a £300 million dividend was paid on 27 March 2012. The amount of any further dividends to be paid prior to divestment from the RBS Group is subject a number of considerations, including FSA non-objection and Board approval. See "*The Issuer and the Group—Description of the Business of the Issuer and the Group—Capital Resources—Capital management actions*".

To the extent any net proceeds are not used to facilitate those capital actions, the remaining net proceeds will be applied for general corporate purposes.

THE ISSUER AND THE GROUP

The Issuer was incorporated on 26 July 1988 as a private limited company with registered number 02280426. On 3 February 2012, the Issuer re-registered as a public limited company and changed its name from RBS Insurance Group Limited to Direct Line Insurance Group plc. The Issuer operates under the Companies Act 2006. The registered office of the Issuer is at Churchill Court, Westmoreland Road, Bromley, Kent BR1 1DP, United Kingdom and its telephone number is +44 (0) 208 313 5810.

DESCRIPTION OF THE BUSINESS OF THE ISSUER AND THE GROUP

OVERVIEW

The Group is a retail general insurer with leading market positions in the United Kingdom and platforms in Italy and Germany. The Group utilises a multi-brand, multi-product and multi-distribution channel business model that covers most major customer segments in the United Kingdom for personal lines general insurance and a more limited presence in the commercial market. The Group occupies leading market positions in terms of in-force policies and has the most highly recognised brands in the United Kingdom for personal motor insurance and personal home insurance. The table below provides certain information with respect to the Group's ongoing and total operations as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	2010	2009
	(millions, £ except policies and ratios)		
Ongoing operations(1)			
Gross written premiums	4,125	4,095	4,172
Operating profit	422	(206)	166
In-force policies	19.4	20.0	20.1
Combined operating ratio	102%	121%	110%
Adjusted return on equity(2)	10.0%	(5.0)%	4.2%
Total operations			
Gross written premiums	4,168	4,971	5,291
Operating profit	344	(375)	(80)
Return on equity(2)	7.5%	(8.0)%	4.3%

(1) Excludes run off businesses and restructuring costs, see "—*Products—Run-off businesses*".

(2) For the Group's calculation methodology, see "*Presentation of Financial Information—Adjusted return on equity*".

The Group's business is comprised of the following five primary segments:

- ***Motor:*** The Group is the leading personal motor insurer in the United Kingdom in terms of in-force policies, with approximately 4.1 million in-force policies and a market share of 19% as at 31 December 2011 (source: GfK NOP Financial Research Survey (FRS) three months ending Dec 2011, 8,000 adults interviewed). In addition to core motor insurance cover of third party liability, fire and theft, accidental damage, and protection for no-claims discount, the Group offers insurance cover that includes motor legal protection and guaranteed hire car. The Group sells motor insurance in the United Kingdom through its own brands—Direct Line, Churchill, and Privilege—and through partnerships with a number of household names, including Prudential, RBS/NatWest, Sainsbury's, Peugeot and Citroen. The Group's brand and product offering covers most major retail customer segments for motor insurance in the United Kingdom. For the year ended 31 December 2011, gross written premiums for Motor were £1,735 million, representing 42.1% of total ongoing gross written premiums for the Group.

- ***Home:*** The Group is also the leading personal home insurer in the United Kingdom in terms of in-force policies, with approximately 4.3 million in-force policies and a market share of 18% as at 31 December 2011 (source: GfK NOP Financial Research Survey (FRS) three months ending Dec 2011, 8,000 adults interviewed). In addition to core home insurance cover of buildings, contents, accidental damage and personal possessions, the Group offers insurance cover that includes family legal protection and home emergency. The Group sells home insurance in the United Kingdom through its own brands—Direct Line, Churchill, and Privilege—and through partnerships with a range of well-known brands, including RBS/NatWest, Nationwide, Sainsbury's and Prudential. As with the motor business, the Group's brand and product offering covers most major retail customer segments for home insurance in the United Kingdom. For the year ended 31 December 2011, gross written premiums for Home were £1,031 million, representing 25.0% of total ongoing gross written premiums for the Group.

- ***Rescue and other Personal Lines:*** The Group's rescue and other personal lines business in the United Kingdom includes rescue and recovery insurance products as well as travel and pet insurance, with approximately 9.2 million in-force policies as at 31 December 2011. The Group's Green Flag brand operates the United Kingdom's third largest roadside rescue and recovery service in terms of members as at 31 December 2011, while it sells its other personal lines insurance through the Direct Line, Churchill and Privilege brands, and through its partnerships, including those with Prudential, RBS/NatWest and Nationwide. For the year ended 31 December 2011, gross written premiums for Rescue and other Personal Lines were £350 million, representing 8.5% of total ongoing gross written premiums for the Group.
- ***Commercial:*** The Group provides commercial insurance for micro businesses and small and medium enterprises ("**SMEs**") in the United Kingdom, with approximately 0.4 million in-force policies and an estimated market share of 8% within the micro business and SME market as at 31 December 2011. The Group's commercial products include commercial property, business interruption, general liability, personal accident and commercial motor insurance, and are sold through its own brands—NIG and Direct Line for Business ("**DL4B**")—and through its partnership with RBS/NatWest. For the year ended 31 December 2011, gross written premiums for Commercial were £439 million, representing 10.6% of total ongoing gross written premiums for the Group.
- ***International:*** In addition to its UK business, the Group sells motor insurance in Germany and Italy primarily through its Direct Line brand. The Group sells its motor insurance to private customers in Germany and Italy (which represent the two largest motor vehicle markets in Europe) using a multi-channel strategy similar to that used in the United Kingdom, with approximately 1.4 million in-force policies as at 31 December 2011. In line with growing market interest in the direct distribution channel in Germany and Italy for general insurance, the Group's international segment has grown, in terms of gross written premiums at a CAGR of 26.9% from 2009 to 2011. For the year ended 31 December 2011, gross written premiums for International were £570 million, representing 13.8% of total ongoing gross written premiums for the Group.

Beginning in late 2009, the Group undertook the first stages of its transformation plan encompassing a range of initiatives aimed at improving profitability and better leveraging the competitive advantages it holds through its brands and large scale. The key aspects of those initiatives included significantly enhancing the Group's pricing capabilities, discontinuing certain unprofitable business lines, rationalising certain operations and significantly increasing its technical reserves relating to prior year claims. See "*—History of the Business—Development of the Group*". Going forward, the Group will continue to rebuild its competitive advantage and has begun implementing a second set of initiatives with respect to pricing, claims, cost efficiency, risk and capital management and employee engagement, with an overall objective of delivering a disciplined, profitable business.

KEY STRENGTHS

Management believes that the Group has a number of key business strengths, as set out below:

Leading UK retail general insurer with strong brands

The Group is the leading personal motor insurer in the United Kingdom in terms of in-force policies with a market share of 19% and the leading home insurer in the United Kingdom in terms of in-force policies with a market share of 18% (in each case as at 31 December 2011). The Group's two core brands, Direct Line and Churchill, have been major contributors to the Group's success. Both Direct Line and Churchill are the most highly recognised personal motor and home insurance brands by UK customers (source: Nunwood Brand Tracking, Motor and Home Top 3 Box Consideration Scores, March 2011 to February 2012). The Group believes the strength of its brands is a competitive advantage in the United Kingdom, thereby supporting strong customer retention rates—in 2011 Motor retention rates for Direct Line and Churchill were 79% and 73% respectively, compared with 71% for the UK motor insurance market generally (source: GfK NOP Financial Research Survey (FRS) three months ending Dec 2011, 8,000 adults interviewed)—and increasing cross-selling opportunities for the Group (as discussed further below).

Multi-channel distribution model allows brand deployment across distinct customer segments

The Group utilises a multi-channel model to distribute its insurance products, and looks to optimise the mix of these channels for each of its products and brands. The channels used by the Group include direct to consumer sales, including over the phone, via the internet and through PCWs, as well as through banks and other partners, and broker channels. By tailoring the distribution channel mix for each product the Group can target its powerful brands across distinct customer segments, seeking to offer its customers a combination of brands, channels, product features, prices and services that best addresses their needs. The Group derives extensive pricing and claims data from those customers, which enhances the quality and quantity of data that can be used in the Group's pricing models and, in turn, assists the Group in its aim of generating superior operating performance.

Direct customer relationships provide cross-selling opportunities for extensive product offering

The Group sells a substantial majority of its motor and home policies through direct to customer sales channels including phone, the internet and PCWs, which provides an opportunity for the Group to develop ongoing and direct relationships with its customers. Direct customer relationships allow the Group to leverage its extensive range of insurance products (such as pet, travel and rescue products) to enhance cross-selling opportunities. For the year ended 31 December 2011, 53% of Direct Line home insurance customers and 37% of Churchill home insurance customers also had motor insurance with those brands.

Experienced management team with strong recent track record

The depth of individual experience on the management team is complemented by the breadth of suitable experience on the team overall. Members of this team have driven the transformation plan for the Group, the implementation of which began in late 2009 when the Group began initiating significant changes to its pricing model, particularly for motor insurance, designed to reduce overall exposure to higher-risk policyholders (such as young drivers), discontinuing certain unprofitable business lines such as personal lines business sold via brokers, certain fleet and taxi business, as well as working to reduce the number of operations centres, both in its personal lines and commercial lines business, from 34 at the beginning of 2010 to 19 at the end of 2011. In addition, the Group significantly increased its technical reserves relating to motor bodily injury. Management believes that a key indicator of the team's success is shown by the Combined Operating Ratio for Motor falling from 126% and 144% for the years ended 31 December 2009 and 2010, respectively, to 106% for the year ended 31 December 2011.

Conservative investment strategy

The Group has pursued a conservative investment strategy focused on liquid and strongly rated investment grade fixed income securities, primarily corporate and sovereign bonds with a "A" rating or better from a ratings provider within either the Standard & Poor's or Moody's group. As at 31 December 2011, 99% of the Group's investment portfolio was invested in fixed income securities and cash, with approximately 70% of the portfolio invested in debt securities (comprising government bonds, corporate bonds and mortgage-backed securities). Approximately 95% of the debt securities were held in "A" rated or better assets, with an overall duration of 2.9 years.

Strong, well-capitalised balance sheet

The Group maintains a level of capitalisation commensurate with its risk appetite, and manages its balance sheet in accordance with regulatory, rating agency and internal economic capital metrics. As at 31 December 2011, the Group had an IGD surplus of £2.4 billion, and an IGD coverage ratio of 319%, although this surplus and ratio will be impacted by the Group's intended capital actions, see "*—Capital Resources—Capital management actions*". The Guarantor (U K Insurance, the Group's principal operating entity) is currently rated "A" by Standard & Poor's and "A2" by Moody's. Both Standard & Poor's and Moody's have predicated their insurance financial strength ratings on completion of the planned capital management actions (see "*—Capital Resources*").

STRATEGY

The Board's goal is for the Group to be recognised as "Britain's best retail general insurer". The initial priorities of the Group's transformation plan were the strengthening of the management team, the implementation of certain pricing, claims and cost initiatives and increasing its technical reserves (See "*—Key Strengths*"). The next phase of the transformation plan involves taking steps to rebuild the Group's competitive advantage by seeking to generate superior performance in pricing, claims and operating efficiency, with the final phase and ongoing goal being to deliver a disciplined, profitable business with a sustainable return on equity. Key elements of this strategy are set out below:

Rebuilding competitive advantage

The Group believes there is significant potential to leverage its scale to improve the sophistication of its approach to pricing, claims and operational efficiency to rebuild the Group's competitive advantage in the medium term. This involves a number of initiatives including the following:

Pricing: The Group is improving its internal and external data collection, analysis and application of this data, better utilisation of the significant volume of existing and historical data that the Group has generated through the scale of its operations and broad market coverage, and enhancements to its pricing models and systems. The Group believes these improvements should enhance its underwriting and risk selection, help it price its products more accurately, and help it to implement pricing changes more quickly and efficiently than previously. As a result, the Group has been able to make significant changes to its risk mix more quickly, particularly for motor insurance, where the Group has reduced its overall exposure to higher-risk policyholders, such as young drivers, and updated its pricing models to more accurately reflect both technical and market pricing information. This includes seeking to exploit its capability to use multi-dimensional pricing models, which the Group intends to improve further with a view to enabling a more refined level of pricing to be achieved based on available data. Given the current insurance climate, the Group believes that, over the medium term, increased sophistication in pricing and underwriting should help improve its risk management and help generate higher returns within the business.

Claims: The Group launched a new claims system in 2011 and expects to bring the majority of new UK claims onto one common system by the end of 2013. The new common claims system will promote increased analytical capabilities as well as enhanced operational control, including areas such as records management. All new motor claims for the Group's own brands (not including commercial motor claims) have been processed on the system since November 2011. Management believes the new system, coupled with a range of other initiatives such as increased detection of fraud and more efficient supply chain management, should result in increased benefits from more proactive claims management, including third party bodily injury claims. The Group subjects major strategic claims initiatives to statistically-based pilot testing before fully rolling out across operations, in order to ensure those initiatives achieve the desired benefits and are appropriate operational processes. All new home claims are scheduled to be processed on the Group's new claims system by the end of 2012 with commercial claims following in 2013.

Operational efficiency: The Group began a site rationalisation programme in 2010 and had exited 15 operating sites by the end of 2011. It aims to exit up to a further 4 sites by end 2012 and to reduce the number of operating sites to 15 by 2014. The Group intends to focus on reducing other operational costs, including through continued efforts to simplify its internal organisational structure. As costs are migrated from the RBS Group to the Group through the separation programme, the Group will continue to evaluate its operations with the aim of making further progress in operating more efficiently.

Risk and capital management: The Group benefits from a strong capital position, and has undertaken several initiatives to improve its capital efficiency, including the rationalisation of its UK general insurance legal entity structure in 2011, obtaining credit ratings from Standard & Poor's and Moody's, for U K Insurance, and this Offering. The Group is in the process of introducing an enterprise risk management framework in preparation for its separation from the RBS Group, which is designed to enhance the Group's risk management processes and with a view to ensuring readiness for Solvency II (see "*—Risk Management—Enterprise-wide risk management framework*" on page 97). In addition, the Group seeks to maintain a conservative investment portfolio. The Group is taking steps to be ready for Solvency II implementation in advance of the required implementation date, with significant focus on developing and enhancing its internal model and associated processes in 2012.

Employees: The senior management team recognises the importance of recruiting, developing and nurturing the significant pool of talent that exists within the Group, and intends to continue to build and develop its employee engagement through programmes such as "Best for Employees", which was launched in 2011.

Delivering a disciplined, profitable business

Following its return to profit, and in conjunction with its initiatives to rebuild competitive advantage, the Group intends to capitalise on its key strengths to deliver a disciplined, profitable business with a sustainable return on equity. Key initiatives in the Group's businesses will be to focus on developing products and services structured to meet the varying needs of its customers; expand the availability of these products through PCWs, and leverage its partnerships to provide the Group with excellent access to customers and data. Each of these initiatives will be aimed at developing long-term customer relationships. Management believes these efforts will help capture market growth and further enhance the Group's ability to cross-sell its products. Within its commercial business, the Group intends to focus on the emerging trend for broker e-trading and direct distribution in the micro business and SME markets, leveraging key strengths in these areas the Group developed in its personal lines businesses. While focusing on these efforts, the Group will continue to focus on maintaining a firm commitment to discipline in pricing, claims management, cost control, and risk management.

HISTORY OF THE BUSINESS

Development of the Group

Direct Line was launched in 1985 in partnership with the RBS Group and was subsequently wholly-acquired by the RBS Group in 1988. The Group's aim was to bring new standards of service and simplicity to the private motor insurance industry by dealing directly with the customer over the telephone. Direct Line was able to "cut out the middle man" and offer a faster, more efficient and convenient service. In 1990, Direct Line used the red telephone on wheels for the first time in television commercials, and the symbol has since become synonymous with the Direct Line brand. In 1999, Direct Line began to operate through the internet channel and quickly grew to become a leading UK internet general insurance provider. In addition to motor, Direct Line began to offer home insurance in late 1988, with pet and travel products being launched in 1997.

In 1998, the Group began expanding its portfolio of UK insurance brands, purchasing Privilege Insurance Company Limited ("**Privilege**"). In 1999, the Group acquired Green Flag Holdings Limited ("**Green Flag**"), the motoring assistance network, and began offering motor rescue and emergency breakdown cover. U K Insurance, which is now the Group's principal UK statutory general underwriting entity, was a subsidiary of Green Flag Holdings Limited.

Also in 1999, the RBS Group launched Tesco Personal Finance Limited ("**TPF**"), a 50:50 joint venture with Tesco plc ("**Tesco**"). As part of this relationship, the Group underwrote a range of general and life insurance products under the Tesco brand. The RBS Group sold its share in TPF to Tesco in July 2008, but the Group has ongoing arrangements in relation to TPF which are described in "*—Products—Run-off businesses*" below.

The Group began its international expansion in 1995 through the creation of Linea Directa, a direct motor insurance joint venture with Bankinter in Spain. In 2001, the Group acquired the European motor insurance businesses of Allstate Corp, which had operations in Germany and Italy, and in 2002, it acquired the business of Royal Insurance from R&SA Assicurazioni. These businesses were rebranded as Direct Line and gave the Group a footprint in Europe's two largest motor vehicle markets.

During the period culminating in the acquisition of the Churchill Insurance Group PLC in 2003, the Group experienced rapid growth in gross written premiums for its motor business, with core operating ratio outperforming the overall UK motor market. The Group acquired Churchill Insurance Group PLC from Credit Suisse Group, which included the general insurance companies, Churchill Insurance Company Limited (together, "**Churchill**") and The National Insurance and Guarantee Corporation Limited ("**NIG**"). This acquisition enhanced the Group's distribution and product capabilities by adding a number of key long term partnership distribution agreements, including Prudential and Nationwide, as well as broker arrangements and commercial insurance through NIG. Together with Direct Line and Privilege, the acquisition of Churchill substantially increased the Group's customer base and established the Group's current UK brand portfolio, allowing it to offer personal motor, home and other insurance through multiple channels to most major UK customer segments.

Following the change in control of the RBS Group in 2008, when HM Treasury became the majority shareholder in RBS Group plc, Bankinter exercised an option in 2009 under the Linea Directa joint venture agreement to buy out the RBS Group's 50 per cent. stake in the Spanish business.

Through the late 1990s and 2000s, industry-wide changes in credit hire, bodily injury claims driven by increased penetration of claims management companies, an increase in no-win/no-fee arrangements, and increases in PPO penetration substantially increased the demands on the Group's operating models and systems including complex and geographically fragmented UK claims management processes. The combination of these events had a negative impact on Group trading and resulted in a period of financial underperformance for the Group, whereby operating losses of £79.5 million and £375.4 million were incurred in the years ended 31 December 2009 and 2010, respectively. At the end of 2009, the Group initiated a transformation plan encompassing a range of initiatives to address the underperformance. The key aspects of those initiatives included significantly enhancing the Group's pricing capabilities (particularly for motor insurance, including reducing overall exposure to higher risk policyholders such as young drivers), discontinuing certain unprofitable business lines such as fleet and taxi business, as well as working to reduce the number of operations centres, both in its personal lines and commercial lines business, from 34 at the beginning of 2010 to 19 at the end of 2011. In addition, in 2009 and 2010, the Group significantly increased its technical reserves relating to motor bodily injury. In 2010, the Group withdrew from its NIG personal lines business sold via brokers and in 2011, the Group ceased writing new life business in its Direct Line life insurance business and sold its motorcycle insurance broker business.

Having taken these steps, the Group is seeking to rebuild its competitive advantage and has begun implementing further initiatives with respect to pricing, claims, cost efficiency, risk and capital management and employee development. For example, in December 2011, the Group completed the reorganisation of its UK statutory general underwriting entities into common ownership under one entity, U K Insurance, which now conducts all underwriting activities for the Group's UK business. This was done to streamline internal operations in anticipation of the new EU Solvency II regulations.

Several of the Group's transformation plan initiatives are still in progress, and some remain in their early development stages.

2011 financial performance

Following the actions taken as part of its transformation plan in 2009 and 2010, the Group delivered significantly improved financial performance for its ongoing business in 2011. Operating profit for ongoing business improved to £422 million for the year ended 31 December 2011 compared with an operating loss of £206 million for the year ended 31 December 2010. This resulted in a significant increase to adjusted return on equity, which was 10.0% compared with (5.0%), respectively. The improvement in operating profit from ongoing business for the year ended 31 December 2011 was primarily a result of improvements to the Group's motor business, where the combined operating ratio improved to 106% compared with 144% for the year ended 31 December 2010. This reflected management actions to increase pricing, exit unprofitable lines of business and reduce overall exposure to higher risk policyholders. The improvement also reflected benign weather compared with 2010, while the Group's operating loss in the year ended 31 December 2010 was impacted significantly by increases to technical reserves relating to UK motor bodily injury. In 2011 the reserves relating to UK motor bodily injury across prior years were stable overall. As a result, the Group's combined operating ratio for ongoing business improved to 102% for the year ended 31 December 2011, compared with 121% for the year ended 31 December 2010.

In-force policies for ongoing business fell by 3% during the year ended 31 December 2011, reflecting lower volumes in the Group's motor business, partially offset by in force policy growth in the Group's commercial and international businesses.

Investment return from ongoing business decreased to £239 million for the year ended 31 December 2011 compared with £281 million for the year ended 31 December 2010 as a result of lower yields, while other operating income from ongoing business decreased to £256 million for the year ended 31 December 2011 compared with £329 million for the year ended 31 December 2010, mainly due to lower instalment income.

Total operating profit for ongoing business excludes operating losses in the Group's run-off businesses of £24 million for the year ended 31 December 2011 compared with an operating loss of £141 million for the year ended 31 December 2010, as well as restructuring and other one-off costs of £54 million for the year ended 31 December 2011 compared with £29 million for the year ended 31 December 2010. The higher operating loss for the Group's run-off businesses for the year ended 31 December 2010 also was impacted by increases to technical reserves. Combined with the improved financial performance for the Group's ongoing business, the Group's overall operating profit was £344 million for the year ended 31 December 2011 compared with an operating loss of £375 million for the year ended 31 December 2010, resulting in a return on equity of 7.5% compared with (8.0%), respectively.

Separation from the RBS Group

In 2009, the RBS Group committed to the European Commission to sell its insurance business as a condition of its receipt of State Aid. To comply with this requirement, the RBS Group must cede control of the Group by the end of 2013 and must have divested its entire interest by the end of 2014.

Distribution agreement with RBS/NatWest

Prior to its divestment from the RBS Group, the Group plans to enter into an arms length, five-year distribution (or "partnership") agreement that will revise the terms of the current commercial partnership with RBS/NatWest. The RBS/NatWest partnership is a significant contributor to the Group's total gross written premiums within its Home segment (approximately 20% in the year ended 31 December 2011). The terms of the agreement are yet to be finalised but the Board believes that the changes to the arrangements will not be material in the context of the Group.

German business

While the German operations of the Group are (and have been) managed as if part of the Group, and have been combined in the Group's Historical Financial Information, the legal entity in which these operations sit was not a direct or indirect subsidiary of the Issuer until 2 April 2012, when the ownership of Direct Line Versicherung AG was transferred from the RBS Group to the Issuer for €145 million.

Operations and systems separation

As a result of the requirement for the RBS Group to divest the Group, in early 2011 the Group commenced a major project to separate its operations from the RBS Group. The project will transfer, replace or replicate, or make subject to the TSA, the essential assets, services, processes and governance, which are currently provided by the RBS Group. Customer facing operations are already largely separate from the RBS Group. Therefore, the principal initial separation requirements involve head office and controlled functions, including finance, risk, human resources, company secretariat, legal, internal audit, corporate communications, property and logistics, and purchasing functions while IT and certain other services will be provided under the TSA for a period.

Other separation actions

In addition to the actions being taken by the Group with respect to operations and systems separation in anticipation of the planned divestment from the RBS Group, there are various specific reorganisation arrangements that are being implemented between the RBS Group and the Group during 2012, the most significant ones of which are:

- ***Property leases:*** In preparation for divestment, the Group is likely to assume from the RBS Group the ongoing lease obligations in relation to certain properties that are currently used, or have until recently been used, by the Group. Some of these properties have recently been vacated by the Group as part of the site rationalisation programme. To the extent those properties remain vacant, the Group may be required to make an appropriate provision in accordance with applicable accounting standards (see "*—Strategy—Rebuilding competitive advantage—Operational efficiency*").
- ***Pensions:*** The Group is in the process of standardising the employment terms of all Group employees. Changes to the employment terms of a small proportion of Group employees who are currently members of the RBS Group defined benefit pension scheme, which are expected to occur prior to or the divestment from the RBS Group, will result in the crystallisation of a debt under section 75 of the UK Pensions Act 1995 (the "**Section 75 Debt**") that the Group would be required to pay into the RBS Group's defined benefit pension scheme (in which such employees will cease to participate) as a result of a deficit in that scheme. The Section 75 Debt is calculated based on the amount needed to secure the Group's share of the pension liabilities in the pension scheme with an insurance company. Based on the most recent available valuation information, the Board understands that the amount of the Section 75 Debt would have been approximately £33 million before tax and £24 million after tax as at 29 February 2012. However, the actual value of the Section 75 Debt crystallised will depend on actuarial estimates and market conditions at the time of crystallisation.

The impact of these two one-off separation related items, together with other one-off and exceptional costs of divestment and separation from the RBS Group relating to human resources and payroll, head office, governance and controlled functions, are significant and are currently estimated to be in the range of £125 million to £175 million, before any applicable tax deduction. These costs, which may be capitalised in part, are expected to be incurred during 2012. This does not include costs relating to migration of the Group's IT services referred to in "*—IT migration*" below.

IT migration

The Group will continue for a period of time to rely on the RBS Group for significant IT services, including IT infrastructure and communications, certain logistics services and certain other services. These services are expected to be provided under the TSA between the Group and the RBS Group. The Group intends to enter into the TSA prior to divestment. In connection with the migration of the IT services to the Group during and at the end of the TSA period, the Group will be making a significant investment in its own IT to prepare for and execute that migration, and expects to incur one-off costs in the region of £100 million, before any applicable tax deduction, associated with this effort over the next two to three years. This amount, which may be capitalised in part, does not include additional operating costs to be incurred under the TSA. (see "*—Information Technology*" as well as "*Risk Factors—Risks relating to the Group—The Group's operations support complex transactions and are highly dependent on the proper functioning of information technology and communication systems*" and "*Risk Factors—Risks relating to the Group—The Group will rely on a transitional service agreement with the RBS Group, particularly with respect to IT services*").

PRODUCTS

The Group's five primary segments are motor, home, rescue and other personal lines, commercial, and international, of which motor, home, and rescue and other personal lines comprise the Group's "UK personal lines" business. The Group sells its products across a range of brands, allowing it to tailor its products to different market segments.

Brands

The Group sells insurance through a range of its own brands and several partnership brands. The following table provides a high level summary of the different general insurance products sold within each of the Group's own brands and principal partner brands:

Brand	Motor	Home(1)	Rescue and other PL(2)	Commercial	International
Own brands					
Direct Line	✓	✓	✓	✓	✓
Churchill	✓	✓	✓		
Privilege	✓	✓	✓		
Green Flag			✓		
NIG				✓	
DL4B				✓	
Principal partner brands					
Prudential	✓	✓	✓		
RBS/NatWest	✓	✓	✓	✓	
Nationwide		✓	✓		
Sainsbury's	✓	✓	✓		

(1) Includes home and home emergency insurance

(2) Includes rescue, pet, and travel insurance

Own brands

The core own brands of Direct Line, Churchill, and Privilege together accounted for 72% of gross written premiums for the Group's UK personal lines business in the year ended 31 December 2011, and substantially all gross written premiums within the Group's motor business. The Group markets its Direct Line brand directly to consumers through channels including telephone and the internet; Direct Line is not available through PCWs in the United Kingdom. Direct Line offers the full range of Group products and is the primary brand through which Group products are offered in Italy and Germany (including through

PCWs). The Group markets its Churchill and Privilege brands directly to consumers in the United Kingdom through channels including telephone, the internet and PCWs. Churchill and Privilege offer most of the Group's products in the United Kingdom to individuals. Green Flag is the Group's primary roadside rescue and recovery service product, sold both as a stand-alone service and as an add-on to motor insurance. NIG is a Group brand that specialises in commercial insurance products for SMEs in the United Kingdom sold through intermediaries including BIS, which is an in-house intermediary that brokers all the RBS/NatWest business. The Group also markets commercial insurance products for SMEs in the United Kingdom directly through its DL4B brands.

Principal partner brands

The Group offers many of its core products, including motor, home, and rescue and other personal lines through the Prudential, RBS/NatWest and Nationwide partner brands, and these three brands represented a significant portion of the Group's gross written premiums for the Group's home products in the year ended 31 December 2011. Collectively, the Group's partner brands accounted for 28% of gross written premiums for the Group's UK personal lines business in the year ended 31 December 2011. The Group also offers commercial products through the RBS/NatWest brand. The Group offers home products through the Nationwide partner brand and motor, home and rescue products through the Sainsbury's partner brand. The Group also maintains several smaller partnership arrangements in both its UK and international businesses.

Motor

The Group is the leading personal motor insurer in the United Kingdom in terms of in-force policies, with approximately 4.1 million in-force policies and a market share of 19% as at 31 December 2011. The table below provides certain information with respect to the Group's motor insurance business as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	2010	2009
	(millions, £ except policies and ratios)		
Gross written premiums	1,735	1,902	2,067
Operating profit	255	(417)	(132)
In-force policies	4.1	4.8	5.6
Combined operating ratio	106%	144%	126%

Products

Motor insurance policies are sold through the Group's own brands as well as key partner brands. In addition to core motor insurance cover of third party liability, fire and theft and accidental damage, the Group offers additional covers including motor legal protection and guaranteed hire car.

The Group's Direct Line and Churchill brands are the most highly recognised in the United Kingdom for personal motor insurance. The Group deploys these two brands along with Privilege and its partner brands across distinct customer segments in order to seek to maximise UK market penetration and reduce the risk of its brands cannibalising customers from within the Group. The Group employs a multi brand, multi channel strategy in an effort to reach a wide customer base across the market.

As the leading personal motor insurer in the United Kingdom, the Group seeks to utilise its scale to drive greater accuracy in pricing through more granular segmentation. This has been particularly important in the actions taken since 2009 to de-risk and re-price the Motor book following the losses suffered by the Group in 2009 and 2010. The Group continues to invest in its core insurance capabilities, including implementing a new operating model in claims management and further enhancing its pricing capability, utilising its overall operational scale and customer data. See "—*Claims Management*".

Distribution

The Group sells motor insurance directly to customers over the phone, its own-branded and partner-branded websites, and PCWs. Currently, only Churchill and Privilege own-branded products are available on PCWs, as are a number of the partner brands. The Direct Line brand is only available through direct channels over the phone or internet. Direct Line is not available through PCWs. In 2010, as part of its overall effort to exit unprofitable business lines, the Group took the strategic decision to withdraw from the broker market for private motor policies.

Home

The Group is the leading personal home insurer in the United Kingdom in terms of in-force policies, with approximately 4.3 million in-force policies and a market share of 18% as at 31 December 2011. The table below sets forth certain information with respect to the Group's home insurance business as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	**2010**	**2009**
	(millions, £ except policies and ratios)		
Gross written premiums	1,031	1,034	1,031
Operating profit	112	163	171
In-force policies	4.3	4.3	4.3
Combined operating ratio	95%	91%	91%

Products

The Group sells home insurance policies through its own brands as well as key partner brands. In addition to core home insurance covers of buildings, contents, accidental damage and personal possessions, the Group offers additional covers including family legal protection and home emergency.

As with Motor, the Group employs a multi brand, multi channel strategy in an effort to reach a wide customer base across the market. The Group's Direct Line and Churchill brands are the most highly recognised in the United Kingdom for personal home insurance. The Group deploys these two brands along with Privilege and partner brands such as Sainsbury's, RBS/NatWest, Nationwide and Prudential across distinct customer segments in order to maximise UK market penetration and reduce the risk of its brands cannibalising customers from within the Group. The Group's Prudential, RBS/NatWest and Nationwide partner brands represented a significant portion of the Group's gross written premiums for the Group's home products in the year ended 31 December 2011.

As the leading home insurer in the United Kingdom, the Group seeks to utilise its scale to enhance pricing accuracy, including granular segmentation with a view to enabling a better understanding of overall risk. The Group has augmented its scale advantage by acquiring additional external data to enhance its pricing in certain key areas, particularly low frequency, high impact events such as catastrophes. Incorporation of this data with its own internal experience has led to improved pricing model capability as well as increased sophistication in managing existing customers through renewal pricing. To support its focus on enhanced pricing, the Group has also invested in a new operating model in claims management. See "—*Claims Management*".

Distribution

Home insurance is sold directly to UK customers over the phone, its own-branded and partner-branded websites, and PCWs as well as through branches. Currently, only Churchill and Privilege own-branded policies are available on PCWs along with a number of the partner brands, while the Direct Line brand is only available through direct channels over the phone or the internet. Direct Line is not available through PCWs. In 2010, the Group took the strategic decision to withdraw from the broker market for private home policies due to its overall poor performance.

Rescue and other Personal Lines

The Group is a leading rescue and other personal lines insurer in the United Kingdom, with approximately 9.2 million in-force policies as at 31 December 2011. The table below sets forth certain information with respect to the Group's rescue and other personal lines insurance business as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	2010	2009
	(millions, £ except policies and ratios)		
Gross written premiums	350	336	321
Operating profit	63	83	115
In-force policies	9.2	9.5	8.9
Combined operating ratio	86%	87%	82%

Products

The Group's rescue and other personal lines business includes rescue and recovery insurance products as well as travel and pet insurance. The Group's Green Flag brand operates the United Kingdom's third largest roadside rescue and recovery service in terms of members as at 31 December 2011. Rescue insurance policies range from basic roadside rescue to a full Europe-wide breakdown recovery service. The Group maintains relationships with third-party automobile service garages and collision repair facilities throughout Europe, providing ready access to breakdown cover for its customers while maintaining controls over claims costs.

The Group's travel insurance policies cover medical expenses, financial default of travel suppliers, and other losses incurred prior to or while travelling. The Group's pet insurance policies include cover for veterinary costs for pets that become ill or are injured in an accident, and can include coverage for loss, theft or death of the pet.

During 2011, the Group developed two new personal lines product offerings: income insurance and private insurance. Income insurance provides coverage for loss of income due to inability to work resulting from illness, accident or unemployment. Private insurance is a specialty offering to mid and high net worth customers, consisting of tailored home insurance (including valuables such as art), and can also include motor, pet and travel insurance. The Group sells private insurance directly to customers through personal sales and offers tailored services to meet individual policyholder needs. The Group sells private insurance through its own Direct Line brand as well as through RBS/NatWest and Coutts & Co partner brands.

Historically, the Group sold a small amount of life insurance through its Direct Line brand, and this business was included in Rescue and other Personal Lines. While the Group ceased writing new life insurance policies in 2011, previous policies remain part of the segment, and the Group expects the continued presence of those policies to affect the underwriting result of rescue and other personal lines going forward, although the reserves applicable to this business are an insignificant proportion of the Group's overall reserves.

Distribution

The Group sells its rescue insurance: (i) as a stand-alone product directly through the Green Flag brand; (ii) as an insurance add-on to all Group own brand and certain partner motor policies; and (iii) as part of packaged bank accounts with RBS/NatWest as well as other partner brands. The Group aims to grow its Green Flag business by improving its operating systems as well as expanding the fleet of branded vans and network of recovery providers.

The Group sells travel insurance in several ways, including: (i) as a standalone product directly to consumers through several Group brands; (ii) along side Group branded home insurance offerings; (iii) as part of packaged bank accounts with RBS/NatWest as well as other partner brands; and (iv) along side and as a standalone product through the Group's partner brands.

The Group sells pet insurance direct to consumers as a stand-alone product under Group brands only, leveraging cross-selling opportunities from both home and motor insurance.

Commercial

The Group provides commercial insurance for micro businesses and SMEs in the United Kingdom, with approximately 0.4 million in-force policies and an estimated market share of 8% within the micro business and SME market as at 31 December 2011. The table below provides certain information with respect to the Group's commercial insurance business as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	2010	2009
	(millions, £ except policies and ratios)		
Gross written premiums	439	398	399
Operating profit	(12)	(41)	5
In-force policies	0.4	0.4	0.3
Combined operating ratio	112%	122%	108%

Products

The Group provides commercial insurance for micro businesses and SMEs in the United Kingdom through its NIG and DL4B brands, as well as through its partner brand RBS/NatWest. The Group's commercial products include insurance cover for commercial property, business interruption, general liability, employer liability and commercial motor. While the NIG brand was acquired as part of the Group's acquisition of Churchill and remains its largest commercial insurance brand in terms of gross written premiums, the Group launched DL4B in 2007 to leverage the value of the Direct Line brand in the commercial insurance market, particularly among micro businesses.

The commercial business has access to the Group's large and diverse data pools providing detailed pricing insight to the commercial market. Through its multi-channel distribution model and investment in an e-trading distribution platform, the Group believes the commercial insurance business can benefit from the scale of the Group's overall insurance platform.

Distribution

The Group offers commercial insurance under its NIG brand directly through an extensive network of insurance brokers and a branch network of eight regional centres and two specialist centres for agriculture and multi-cover policies. NIG supports its network of brokers through national and regional relationships. NIG also underwrites insurance for RBS/NatWest customers through the Group's in-house broker BIS, which also brokers such business to the external insurance market where NIG is unable to offer a suitable solution. By contrast, as with other Direct Line products, DL4B is offered direct to consumers over telephone and internet. The Group intends to take advantage of what it believes is likely to be a trend for micro businesses and SMEs to migrate toward new distribution channels such as broker e-trading and direct distribution.

International

The Group sells primarily motor insurance to private customers in Germany and Italy using a multi-channel strategy, with approximately 1.4 million in-force policies as at 31 December 2011. The Group is one of the leading providers of direct motor insurance in both Italy and Germany.

The table below provides certain information with respect to the Group's international insurance business as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	2010	2009
	(millions, £ except policies and ratios)		
Gross written premiums	570	426	354
Operating profit	4	6	6
In-force policies	1.4	1.1	0.9
Combined operating ratio	108%	108%	109%

Products

The Group offers primarily motor but also a very small amount of home insurance through its Direct Line brand in both Italy and Germany. It also offers motor insurance through partner brands such as Fiat in Italy, and has been developing partnerships in Germany. Similar to the Group's UK business, the international business model is based upon the Group's strong brands and multi-channel distribution model.

Distribution

The Group distributes the majority of its international products through the direct channels of telephone and internet. The Group also offers its products in Italy and Germany through PCWs. Partner brands are offered through banks, financial institutions and vehicle manufacturers.

Run-off businesses

The Group has two businesses remaining within its run-off activities. These businesses consist of policies written through the TPF partnership arrangement and NIG personal lines business sold via brokers. In both cases, no new policies have been written since October 2010, save for TPF credit card PPI policies, which the Group will continue to renew on a monthly basis until those policies are migrated to Tesco's new provider. The Group expects to complete this migration in 2012, though the exact date remains subject to change.

The table below provides certain information with respect to the Group's run-off businesses as at and for each of the years ended 31 December 2011, 2010, and 2009:

	Year ended 31 December		
	2011	**2010**	**2009[(1)]**
	(millions, £ except policies)		
Gross written premiums	43	876	1,120
Operating profit	(24)	(141)	(165)
In-force policies	0.0	2.4	3.0

(1) Includes Linea Directa, which the Group sold to Bankinter during 2009. See "*—History of the Business—Development of the Group*".

Tesco Personal Finance

In 1999, the RBS Group entered into a 50:50 joint venture with Tesco called Tesco Personal Finance Limited, pursuant to which the Group underwrote a range of general and life insurance products under the Tesco brand for Tesco Customers (the "**TPF Policies**"). In December 2008, the RBS Group sold its share in TPF to Tesco.

At the time of the sale, the Group terminated the existing TPF contracts and entered into new insurance distribution agreements (one for general insurance business and one for life insurance business) under which it underwrote, sold and administered the TPF Policies and provided certain related insurance services to TPF for a period of approximately two years. Pursuant to those distribution agreements, the Group agreed to provide, after the initial two-year period, ongoing claims and administration services relating to in-force TPF policies for a further two year run-off period, which, under the terms of those agreements, is scheduled to expire on in October 2012 (the "**run-off period**").

At the end of the run-off period, the arrangements provide for the TPF reserves that relate to the TPF Policies to be assessed and then determined by the parties. The Group's approach and strategy for determining the reserves for the TPF Policies is consistent with that applied to the rest of the Group's reserves. If the determination process concludes that there is a reserves surplus in relation to the TPF Policies, the benefit will flow to TPF whilst any determined deficit will be apportioned on the basis set out in the agreements between TPF and U K Insurance. Once the reserve determination process has been concluded, the Group will continue to administer the TPF Policies and remain exposed to the risks under those policies.

In 2006, TPF provided the Group with £255 million of solvency capital which appears in the Group's tier 2 capital as a perpetual subordinated loan (the "**TPF Note**"). At the same time, TPF provided the Group with £3.5 million of solvency capital on similar terms in relation to the TPF life insurance business, which also appears in the Group's tier 2 capital and can be withdrawn at TPF's request. Following determination of the reserves, the Group intends, subject to completion of that process and the consent of the FSA, to repay the TPF Note, although currently this is not expected to happen until 2013. See also "—*Capital Resources—Capital management actions*".

Personal lines business sold via brokers

The Group previously sold a range of personal lines insurance policies, namely personal lines motor, home, pet and travel insurance polices through brokers under its NIG brand. This business was put into run off in the fourth quarter of 2010, such that all policies expired by the end of 2011. The Group will continue to manage the claims arising from this business to final settlement, which it expects could take several years in the case of certain high severity personal injury claims under the motor account.

PRICING

One of the primary initiatives in the Group's turnaround plan has been improving its pricing models and systems. A key component of enhancing the Group's pricing systems has been the deployment of a new pricing engine, which the Group first began using in 2010. Along with the new pricing engine, the Group has been continuing to improve its internal and external data collection, through the acquisition of external data sets and better utilisation of existing data. Together, these systems and data allow the Group to seek to improve the depth and breadth of its overall pricing analysis, implement pricing changes more quickly and efficiently, and price its products more accurately. The new pricing engine has the capability to use multi-dimensional pricing models, which the Group intends to continue to improve with a view to enabling a more detailed level of pricing to be achieved based on available data.

As a result of improving its pricing models and systems, the Group has been able to make significant changes to its risk mix, particularly for motor insurance, where the Group has reduced its overall exposure to higher risk policyholders, such as young drivers, and to update its pricing models to more accurately reflect both technical and market pricing information. Given the current insurance climate, the Group believes that, over the medium term, increased sophistication in pricing and underwriting should help to ensure it manages its risk/reward profile appropriately.

CLAIMS MANAGEMENT

The Group's claims function manages claims activities for all UK insurance products across segments and product lines. A core component of the Group's turnaround plan is improving the infrastructure that supports the Group's current UK claims management processes, which, at the initiation of the Group's transformation plan, were complex and geographically fragmented, and as a result did not facilitate the competitive advantage that a centrally-managed UK claims function could provide to the Group.

The Group believes that an efficient and effective claims management system and associated processes are key to providing superior customer service and controlling claims costs, and the Group applies this philosophy throughout all its claims functions, including those in Italy and Germany. The Group's UK claims function is aiming to improve the performance of its claims operating systems and processes to enable it to manage the cost of claims below market claims inflation and provide enhanced customer satisfaction, for example through faster response times. The UK claims function is particularly focused on efforts to enhance its proactive management of third party claims and to reduce claims fraud and leakage, which, combined with other improvement initiatives, would be expected to enable savings to be reinvested by other areas of the Group.

The UK claims function uses internal resources, including claims advisors, property assessors, motor engineers and the wholly-owned UK Assistance Accident Repair Centres, as well as a wide range of external providers, to register, evaluate, manage, fulfil, handle and close claims. External resources include solicitors, garages, loss adjusters, builders, and household goods suppliers. The Group uses various audit activities both internally and externally across claims in an effort to enhance appropriate, efficient and effective claims handling.

As part of its overall Group transformation plan, the UK claims function is currently undergoing its own improvement programme, which aims to address the complexity, speed and geographic fragmentation of its claims processes. In 2011, the Group implemented a new claims management system and plans to bring the majority of new UK claims onto one common system by the end of 2013. All new motor claims for the Group's own brands have been processed on the system since the end of 2011 and all new home claims are scheduled to be processed on the system by the end of 2012 with commercial claims following in 2013. The new system has been designed to improve customers' claims experience and aims to ensure more efficient and effective claims handling through faster, more accurate claims resolution and simplified coverage validation. In addition, the Group has introduced revised processes for bodily injury and fraud detection and evaluation as well as subsidence claims. The Group's UK claims function is also in the process of consolidating its geographic operations, from 21 operating sites in 2010 to a targeted 9 sites by 2013. See also "*—History of the Business—Development of the Group*". While the Group expects to implement much of the transformation programme for its UK claims management in the next few years, many of its initiatives are still in progress, and some remain in early development stages.

Each of the Group's international businesses in Italy and Germany operate separate claims functions. These functions are modelled on the Group's UK insurance claims function and leverage the knowledge and capabilities of the Group's overall claims expertise, but are tailored to the individual requirements, regulations and practices in each of their respective markets.

REINSURANCE

The Group purchases reinsurance to protect its capital position as well as the results of individual business lines. The primary objectives of the Group's reinsurance programmes are to reduce the volatility of the Group's overall underwriting result, improve the stability of earnings for relevant business lines and transfer out of the Group risks that are outside of the Group's current risk appetite.

The Group seeks to achieve these objectives by transferring certain identified insurance risks out of the Group in the form of reinsurance. The overall analysis of which major reinsurance programmes to purchase utilizes the same models and methodology as those used for evaluating regulatory and economic capital requirements. Reducing volatility in the Group's underwriting results and supporting its capital base is sought to be achieved by purchasing reinsurance for catastrophes and other major individual or accumulation losses. The retained portions of insurance risk are managed at levels that the Group expects it can absorb in accordance with loss models and regulatory capital requirements. The Group seeks to purchase reinsurance at cost effective rates from secure reinsurers within credit risk levels acceptable to management.

The Group purchases reinsurance to provide cover against other substantial individual claims or an accumulation of claims arising from a catastrophe event such as wind, storm or flood. In addition, the Group's international insurance businesses purchase reinsurance to cover a portion of the entire portfolio of underwritten International policies (also known as "quota share reinsurance").

Reinsurance procurement controls and monitoring

The purchase and ongoing management of the Group's reinsurance covers are subject to strict governance and approvals, with differing levels of approval required depending on the extent of the reinsurance proposed and the anticipated level of premium expenditure. Maximum purchasing and retention levels are set by the Board and relevant management while the reinsurance function executes purchasing and monitors reinsurance activities. UK Catastrophe and motor covers must be approved by the Board due to the levels of expenditure. All covers for the Group's Italian and German businesses are approved by the Group's Italian or German management, respectively. The Group performs an annual review on its catastrophe and motor reinsurance programmes and their impact on the Group's required capital, retained and/or ceded profit and earnings volatility.

Assumed credit risk for the Group's reinsurance is monitored monthly by the credit risk forum, an operational committee. The assumed credit risk for the Group's reinsurance exposure is also aggregated over the RBS Group, and the Group expects this will continue for as long as the Group remains under majority control by the RBS Group. See "*Risk Factors—Risks relating to the Group—Reinsurance may not be available, affordable or adequate to protect the Group against losses, and reinsurers may default on their reinsurance obligations*".

The purchase of reinsurance does not discharge the Group from any liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group remains liable for the payment to its customers. Therefore, the Group considers the creditworthiness of reinsurers based on their financial strength prior to finalizing any reinsurance contract. The Group uses selection criteria for assumed reinsurer credit risk based on Standard & Poor's and/or AM Best financial security ratings and other publicly available information, and augments the selection process with reports from its reinsurance brokers as well as regular meetings with its panel of reinsurers.

Unless otherwise approved by the Board, the Group's primary credit rating requirements for reinsurers at the time of purchase are "AA−" or better (with only a limited amount of "A+") for motor and liability excess of loss (long-tail) reinsurance, and "A−" or better for property individual risk and catastrophe excess of loss (short-tail) reinsurance. In a majority of its property individual risk and catastrophe excess of loss reinsurance contracts, the Group also requires a security downgrade clause in the reinsurance contract, providing the Group with the option to replace a reinsurer should it be downgraded below the Group's minimum security threshold rating.

RESERVING

The Group holds technical reserves to ensure it has sufficient funds available to pay its technical liabilities when they fall due. The Group's technical reserves consist of:

- claims reserves to cover the future cost of claims that have occurred prior to the balance sheet date to ultimate settlement, net of reinsurance;
- unearned premium reserves, net of reinsurance;
- loss adequacy reserves, to cover any expected shortfall in unearned premiums reserves for portfolios of business;
- claims handling expense reserves, in respect of unallocated loss adjustment expenses, to cover the unallocated cost of handling all claims which have occurred prior to the balance sheet date to ultimate settlement; and
- reinsurance bad debt reserves, which allow for future non-performance of reinsurance contracts.

The majority of the Group's technical reserves are held to pay motor claims in both the United Kingdom and overseas. Approximately two thirds of the Group's technical reserves are held to pay motor bodily injury claims, which are long-tailed by nature.

Determination of the Group's technical reserves is a complex process, involving analysis of trends in claims costs and payment patterns using a range of actuarial and statistical methods as well as wider impacts to the Group's business, such as market and economic trends. Technical reserves for PPOs, latent claims and reinsurance are determined using bespoke models developed by the Group. The technical reserves held by the Company are subject to risk from wider market changes, such as changes in consumer behaviour (e.g. in relation to the economic environment and fuel prices), changes in the economy, changes in the level of inflation and changes in legislation, which may impact retrospectively as opposed to just prospectively (e.g. changes in the discount rate used to calculate lump sum awards for injured claimants). See "*Risk Factors—Risks relating to the Group—The Group's technical reserves may not adequately cover actual claims*".

Reserve process initiatives

As outlined above, the Group's transformation plan has involved changes to a number of processes and procedures within the Group, including in relation to reserving. The Group took this action in response to both external factors, including the changing trends in the frequency and severity of bodily injury claims occurring in the market, and internal factors, including inaccuracies in reserving that arose from the changing trends in individual claims settlements occurring within the Group's claims function. Drivers of external trends included increases in the propensity of PPO settlements, partially driven by the prevailing low interest rate environment, poorer investment outlook and a court ruling for the payments in respect of future cost of care to be linked to the Annual Survey of Hours and Earnings rather than the traditionally lower Retail Price Index, expectations with respect to possible changes to the Ogden discount rate, increased penetration of claims management companies pursuing more bodily injury claims, and increases in the prevalence of fraudulent claims. These issues resulted in the Group significantly increasing its technical reserves in 2009 and 2010 and changing its claims and reserving operations, processes and procedures.

While there can be no assurance that adverse trends in bodily injury or other types of claims will not occur in the future, driven by whatever cause (see "*Risk Factors—Risks relating to the Group—The Group's technical reserves may not adequately cover actual claims*"), the Group believes the changes it made during 2009 and 2010 to its underlying processes and procedures and reserves held were appropriate to meet the current challenge. Moreover, the Group believes that, having improved its reserving modelling, processes, controls and governance procedures, it should be better able to identify and mitigate any significant emerging trends.

Reserving policy and controls

The Group employs actuarial and other techniques to estimate the expected ultimate value of claims, and associated unpaid liabilities in respect of business which has been earned up to the balance sheet date. These liabilities are estimated net of recoveries from third parties, such as other insurers, and net of reinsurance recoveries. The ultimate value and corresponding unpaid liability is estimated on an undiscounted basis for all claim types except reserves held to cover the expected claims cost in relation to PPOs which are assessed on a discounted basis.

In particular, the estimation of technical reserves in relation to PPOs is complex and uncertain due to the increased range of assumptions required, including the future propensity of such settlement methods, estimated rates of indexation, estimated mortality trends for impaired lives, payment patterns, investment income and the impact of reinsurance recoveries. Further, as the reserves are assessed on a discounted basis, the discount rate which the Group applies is also a significant element of this estimation process.

Currently, the estimated cost of PPO claims is based on an assumed indexation of 4.5% in relation to the future cost of care. In conjunction with this, in the year ended 31 December 2011, the Group applied a 4.5% discount rate to the assessment of technical reserves in relation to the estimated costs of PPO claims. The Board has approved an asset : liability matching strategy in respect of the assets backing these technical reserves.

As at 31 December 2011, the total discounted technical reserves in relation to the estimated costs of PPO claims (including claims incurred but not reported), including both the lump sum and the annual payment elements, were £1,167 million gross and £835 million net of related reinsurance, which equates to around 14% of the Group's total outstanding claims provisions net of related reinsurance. On an undiscounted basis, total technical reserves in relation to the estimated costs of PPO claims (including claims incurred but not reported) were £3,857 million gross and £2,405 million net of related reinsurance as at 31 December 2011.

The Group also maintains an unearned premium reserve in respect of premiums not yet earned at the balance sheet date. Unearned premium reserve represents the proportion of the premiums that have been written prior to the balance sheet date but which relate to periods of risk after the balance sheet date. Provision is also made where necessary for the estimated amount of claims and expenses over and above unearned premiums. The provision is designed to meet future claims and related expenses and is calculated across related classes of business allowing for deferred acquisition expenses and investment income.

The Group conducts actuarial reviews on a regular basis for material reserves. Such reviews are either undertaken internally or by utilising suitable external independent resource. The Group also subjects its internally derived actuarial best estimate reserves to independent external peer review at least annually.

The Group holds reserves in excess of the actuarial best estimate reserves as provision for adverse reserve movements given the natural uncertainty which exists in the actuarial best estimate reserves. These additional reserves are determined by the Board based on a consideration of the risks underlying the assessment of the actuarial best estimate reserves, including, but not limited to, the level of process and parameter uncertainty inherent in actuarial techniques, the level of uncertainty in the standard claims handling processes; potential pricing and underwriting risks; emerging risks; and short and long term binary-type risks not allowed for in actuarial best estimate, for example, a reduction in the Ogden discount rate. The actuarial best estimate reserves, together with the additional provision for adverse reserve movements, forms the overall management best estimate of Group reserves, which is booked in the accounts.

The Group's actuarial and recommended management best estimate reserves are subject to review by various committees and the Board on at least a semi-annual basis. Recommendations for levels of reserves are then presented to the Group's Board, which decides upon the level at which the reserves should be booked.

In addition to the Group's financial reporting, reserve reviews inform management action on claims, pricing, underwriting, reinsurance purchasing, capital modelling and forecasting.

Reserve estimates

The table below sets forth the Group's insurance liabilities (i.e. technical reserves), unearned premium reserve and reinsurance assets as at 31 December 2011, net of reinsurance:

	Gross	Reinsurance assets	Net
		(£ millions)	
Claims reported	4,037	(318)	3,719
Loss adjustment expenses	153	0	153
Notified claims	**4,190**	**(318)**	**3,872**
Liability adequacy provision	3	0	3
Claims incurred but not reported	2,218	(282)	1,936
Total general insurance business	**6,411**	**(600)**	**5,811**
Unearned premiums	1,932	(59)	1,873
	8,343	**(659)**	**7,684**
Life insurance business	98	(83)	15
Total	**8,441**	**(742)**	**7,699**

CAPITAL RESOURCES

Capital management policy

The objective of the Group's capital management policy is to ensure that the Group manages its capital efficiently and maintains 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 economic capital requirement, the maintenance of a prudent excess versus regulatory capital requirements, and the objective of ensuring consistency with a credit rating in the "A" range. The Group also manages its subsidiaries on an ongoing basis to ensure that capital resources exceed regulatory minima in accordance with its current requirements.

The Group uses an economic capital model to determine how much capital it needs to maintain to operate in accordance with its risk strategy for the UK general insurance underwriters established within its enterprise risk management framework (see "*—Risk Management—Enterprise-wide risk management framework*" on page 97). The economic capital model also supports decision making in the business. In addition, the Group also monitors financial resources with reference to the requirements of the IGD.

The UK regulated entities of the Group carry out an assessment of the adequacy of their overall financial resources in accordance with the FSA's Individual Capital Adequacy ("**ICA**") methodology. This is based on an internal capital model which is calibrated, as required by the FSA, to a 99.5% confidence interval over a one year time horizon. As stated above, the Group's capital risk appetite is to hold capital consistent with the Group maintaining a credit rating in the "A" range and as such its capital resources are in excess of the ICA requirement. The capital for European entities is maintained in accordance with the local regulatory solvency requirements.

The Group's leverage policy is to manage financial leverage consistent with its objective of maintaining a credit rating in the "A" range.

Group solvency and financial leverage

The Group is well capitalised with an IGD surplus of £2.4 billion and an IGD coverage ratio of 319% as at 31 December 2011. The table below sets forth the consolidated statutory solvency capital position and IGD capital position as at 31 December 2011, 2010 and 2009:

	As at 31 December		
	2011	**2010**	**2009**
	(millions, £ except ratios)		
Consolidated statutory solvency capital			
Ordinary shareholders equity(1)(2)	3,613	3,224	3,322
Goodwill and other intangible assets	(366)	(286)	(290)
Regulatory adjustments	(26)	(265)	(284)
Total tier 1 capital	**3,221**	**2,673**	**2,748**
Tier 2 capital(3)	259	259	259
Regulatory adjustments	(37)	(141)	(5)
Total regulatory capital resource	**3,443**	**2,791**	**3,002**
European Insurance Groups Directive (IGD)			
IGD required capital(4)	1,079	1,227	1,050
IGD excess solvency	2,364	1,564	1,952
IGD coverage ratio	319%	227%	286%

(1) Excludes £258.5 million undated loan capital reported in tier 2 capital, which includes the TPF Note

(2) Does not reflect the dividend of £300 million paid on 27 March 2012

(3) Includes the TPF Note and £3.5 million of solvency capital provided by TPF in relation to the TPF life insurance business

(4) Based on the IGD for the Group and adjusted to include the capital requirement for Direct Line Versicherung AG

The table below sets forth the Group's financial leverage ratio as at 31 December from 2011, 2010 and 2009:

	As at 31 December		
	2011	**2010**	**2009**
	(millions, £ except ratios)		
Total ordinary shareholders equity(1)	3,613	3.224	3,322
Undated loan capital(2)	259	259	259
Long term borrowings	248	249	251
Total financial debt	**507**	**508**	**510**
Total capital employed	**4,120**	**3,732**	**3,832**
Financial leverage ratio(3)	12%	14%	13%

(1) Does not reflect the dividend of £300 million paid on 27 March 2012

(2) Includes the TPF Note and £3.5 million of solvency capital provided by TPF in relation to the TPF life insurance business

(3) Total financial debt as a percentage of total capital employed

The Group's planned capital management actions will result in a change in the amount and composition of the Group's current capital position and financial leverage. As more fully described below, these actions will be consistent with the Group's capital management policy.

Capital management actions

The Group's contemplated issue of tier 2 capital pursuant to the Offering is a part of a number of capital management actions targeted at creating a more efficient capital structure ahead of the required divestment of the Group from its parent, the RBS Group. The tier 2 capital issue is structured to be eligible for regulatory and rating agency capital treatment. On 10 December 2011, the Group consolidated its four UK general insurance underwriting entities by way of a FSMA Part VII transfer, enabling the Group to benefit in the future from enhanced capital fungibility, greater diversification of risk within a single underwriting entity, and operational efficiency and effectiveness. All of the Group's UK insurance business is now written through the Guarantor (although Churchill Insurance Company has a small number of legacy claims remaining in it). The Group has also exited from relatively capital intensive low-return lines of business, including personal lines business sold via brokers and certain fleet and taxi business lines.

In 2012, the Group expects to pay dividends to its parent company, the RBS Group, in the range of £500 million to £1 billion, of which a £300 million dividend was paid on 27 March 2012. This series of potential payments is subject to various considerations including non-objection from the FSA and approval of the Board for the payment of each dividend as well as consistency with the Group's capital management policy.

The Group also expects to repay intra-group debt owed to the RBS Group of approximately £248 million in 2012, subject to certain conditions. In addition, in 2013, subject to completion of the reserve determination process and the consent of the FSA, the Group intends to repay the TPF Note. See "*—Products—Run-off businesses—Tesco Personal Finance*".

The Group believes implementation of the above actions will be consistent with its capital risk appetite.

Future Dividend Policy

In the event of an IPO of the Group, the Board will set a future dividend policy on the basis of various criteria including the Group's profitability, cash flow position, growth and investment plans and its capital management policy (see also "*—History of the business—Separation from the RBS Group*").

Credit Ratings

Standard & Poor's and Moody's provide insurance financial strength ratings for U K Insurance, the Group's principal UK general insurance underwriter and the Guarantor. U K Insurance is currently rated "A" with a stable outlook by Standard & Poor's and "A2" with a stable outlook by Moody's. Both Standard & Poor's and Moody's have predicated their insurance financial strength ratings on completion of the planned capital management actions. Standard & Poor's and Moody's currently link the financial strength ratings of the Guarantor to the overall rating of the RBS Group. As a consequence, Standard & Poor's has indicated that its rating for the Guarantor could be affected by future rating actions on the RBS Group by Standard & Poor's, while Moody's has indicated that its rating for the Guarantor could be negatively impacted by a substantial weakening of the RBS Group's credit profile.

Solvency II

The Group's Solvency II programme is scheduled to meet implementation requirements and milestones, and the Group participated in Quantitative Impact Study 5. Significant progress has been made to date, including the delivery of the technology infrastructure, and the first stages of the Solvency II data warehouse and risk management system. Development of the internal capital model and embedding Solvency II processes within the business are ongoing in preparation for the submission by the Guarantor of its internal model for approval. Given the uncertainty surrounding the requirements of Solvency II, including the date of its implementation, there can be no assurance that the Group will not need to strengthen its solvency capital position.

INVESTMENTS

The Group makes investments primarily to cover its technical reserves. The Group aims to manage its portfolio to maximise return relative to the Group's risk appetite and to serve as a stable income generator while providing a match to the Group's technical reserves and liquidity needs. In 2011, investment return decreased somewhat, with lower yields partly offset by higher realised gains.

As the majority of the Group's liabilities are short-tailed, fixed income investment constitutes a major part of the investment portfolio. A large portion of the portfolio consists of cash, gilts and other bonds. The Group's overall investment portfolio consists of two primary individual portfolios, the UK core portfolio, which covers the Group's UK business (other than its business with TPF which is currently being run off, see "*—Products—Run-off businesses*"); and its Euro-denominated International portfolio, which covers the Group's International business. The TPF portfolio, which covers the run-off liabilities associated with that partnership arrangement, is currently segregated from the remaining portfolio pending the claims reserve determination scheduled to commence in late 2012. Following final determination and the effective closure of the arrangements with TPF, any remaining investments will form part of the UK core portfolio.

Prior to 2011, responsibility for managing the investment and treasury function for the insurance business was housed within the RBS Group's central treasury function. As part of the separation process from the RBS Group, the Group is establishing a separate investment and treasury function, reporting directly into the Group's finance director. Cash and gilt portfolios will be managed directly by an in-house team while management of other asset classes is being awarded to leading external managers. In addition, the Group has implemented new systems to provide better investment accounting, reporting, analytics, and risk management as well as to support front office dealing activities.

Investment portfolio

The income from, and value of, the Group's investments have a significant impact on its financial results and capital resources position. Return on investments (calculated as investment income as a percentage of the average financial assets) for each of the years ended 31 December 2011, 2010, and 2009 was 2.3%, 2.6% and 3.2%, respectively.

The table below sets forth the asset allocation of the Group's portfolio based on the currency in which the assets are held, translated into British pounds sterling as at 31 December 2011:

	Cash							
	Cash	Short term deposits(1)	Long term deposits(2)	Govt Bonds	Corp Bonds	MBS(3)	UCITS(4)	Property
	(£ millions)							
Total	**202**	**1,178**	**1,490**	**3,481**	**3,843**	**284**	**383**	**70**

(1) Short term cash deposits have a maturity of less than three months

(2) Long term cash deposits have a maturity of more than three months

(3) Mortgage backed securities

(4) Undertakings for collective investment in transferable securities. The underlying investments consist primarily of global corporate bonds.

Apart from cash for operations held with local banks in Italy by Direct Line Insurance S.p.A., the Group had no cash deposits with banks in Greece, Ireland, Italy, Portugal or Spain.

Investment strategy and controls

The investments of the Group are managed within the limits of the Group's investment guidelines, as agreed by the Group's investment committee, which are based on overall risk and target income. The Group expects this management to be done by its investment and treasury function, incorporating the use of appropriate mandates for external managers where appropriate, though this remains subject to completion of the final separation of the function from the RBS Group.

In connection with the establishment of a separate investment and treasury function, the Group has begun managing its investment portfolio based on the following criteria, the effects of which are expected to be realised over the medium term:

- To ensure liquidity, the portfolio must include a minimum of 10% in cash;
- The target asset mix for the UK core portfolio is approximately currently 60% credit, 25% gilts, 10% cash, 5% property and asset backed securities;
- Within credit investments the minimum acceptable investment grade at purchase is BBB (positions falling to BBB− must typically be sold within 30 days);
- Derivatives are permitted for risk management only (gearing not allowed); and
- No investment in equities.

As part of the implementation of the new investment management function and the incorporation of external managers, the composition of the Group's investment portfolio as at 31 December 2011 is likely to change to include less cash and more credit assets, within the above guidelines. In addition, the Group is considering future changes to the nature and type of investment portfolio it holds with the aim of increased diversification, through changes in the mix of asset type, duration, currency and denomination. In particular, the Group is considering investing a portion of its assets in instruments denominated in US dollars (which it would plan to hedge back into British pounds sterling) and real estate (where it currently has a small exposure in the United Kingdom). The Group may in the future invest in equities, although currently there are no plans to do so.

The International portfolio is managed by the Group's international businesses based on a similar set of criteria.

Effective implementation of the Group's investment strategy requires monitoring of the different risks affecting its portfolio. The risk framework surrounding investment activity, including counterparty limits, minimum required investment grade, and liquidity requirements are approved by an executive or Board committee. The Group's risk function operates a variety of processes in order to act as an independent arbiter of the appropriateness of and compliance with approved investment risk parameters and limits through its own assessment and formal meetings with the Group's investment and treasury function, escalating key concerns to the relevant higher committee.

RISK MANAGEMENT

Risk management, incorporating the identification, assessment, management, control, reporting and mitigation of risk, is a fundamental part of the daily operations and ongoing performance of the Group. The Board believes the Group's recently adopted enterprise-wide risk management strategy and framework will support the Group in achieving its strategic risk objectives, namely maintaining capital adequacy, managing earnings volatility, ensuring stable and efficient access to funding and liquidity, and maintaining stakeholder confidence.

The Board has overall responsibility for the risk and control environment in the Group, including setting the Group's risk appetite, risk strategy and target operating model, and risk management and internal control systems.

In this, the Board is supported by the risk and audit committee, which is expected to be separated into a Board risk committee and an audit committee at a future date, as well as the risk and internal audit functions, which together define, oversee and challenge the risk and control environment of the Group, including the operation of the business within its risk appetite. As part of this, the risk function advises the risk and audit committee on risk appetite and supports the business by maintaining the risk management framework and defining the associated processes. In addition, the Group's internal audit function provides independent assurance over the adequacy and effectiveness of the design and implementation of the Group's risk management framework.

Enterprise-wide risk management framework

To achieve its overall risk management objectives, the Group has adopted an enterprise-wide risk management strategy and framework, which it expects to continually enhance in the future. The key elements of this strategy and framework are described below.

In the past two years, the Group has enhanced its risk management and internal control culture across the business through appropriate training and communications, as well as enhancing the number and skills and capabilities of individuals in its risk function and in operational areas. Central to this effort was the appointment of a dedicated chief risk officer toward the end of 2009.

Over the same period the Group has also continued to develop its risk management and internal control governance structure.

The Board oversees the business operations within the Group, aimed at ensuring competent and prudent management and the maintenance of adequate procedures for accounting, financial and other records management as well as compliance with statutory and regulatory obligations. Key aspects of the Board's ongoing oversight of the risk strategy and enterprise-wide risk management framework includes items such as regular reporting, review of the risk appetite framework, the ICA assessment for the UK regulated entities, and use of the capital model in decision making.

The Board has responsibility for approving the methodologies, approaches and assumptions used to identify measure, monitor, report, control, and mitigate the Group's risk exposures and, hence, overseeing and challenging the risk and control environment of the Group. The Board delegates its authority in relation to certain aspects to the risk and audit committee, which is a committee of the Board composed of non-executive directors which meets a minimum of once a quarter. Its risk management responsibilities include:

- ***risk profile and appetite:*** approving the risk appetite framework, monitoring and proactively challenging the risk performance of the Group and reports from the risk and internal audit functions;

- ***risk strategy and policy:*** reviewing the implementation of risk management strategy and policy across the Group, monitoring the adequacy and effectiveness of the Group's internal control framework and considering the Group's risk profile; and
- ***risk management operating model:*** approving the risk and internal audit operating plan and considering the adequacy and effectiveness of resource dedicated to risk management and internal control, including the risk and internal audit functions.

The managing directors are the first line of defence operating a range of committees and other forums to oversee risk within their areas of responsibility (e.g. pricing committees and loss ratio committees).

Day to day responsibility for managing risk rests with the chief executive officer and is supported by the executive committee. The executive committee will, among other things, review and approve or, where appropriate, escalate to risk and audit committee relevant recommendations on risk management matters including risk appetite, risk policies and risk management strategies. This includes reviewing and approving material policies for the effective management of risk across the organisation, including those associated with Solvency II. As part of this, the risk function produces a report each month to the executive committee and the Board that covers the material risk considerations for the Group, including details of any new and emerging risks.

The role of the capital management committee is to consider and challenge the ICA for the UK regulated entities and monitor the solvency position of all the Group's regulated entities as well as the Group overall. It also considers options to appropriately optimise the Group's capital in accordance with all regulatory and Board requirements and objectives, in order to maximise the capital efficiency and return on capital of the insurance regulated entities and the Group as a whole.

The Group has also established a reserving review committee that meets at least quarterly and loss ratio committees for each UK product category that meet at least monthly to review and oversee the claims development trends and technical reserves. In addition, there are other forums which consider and oversee specific risk types (e.g. the insurance risk forum).

The Group has developed a policy framework to govern its risk and control activities and expected behaviours across all of its businesses. The policy framework has been formed under an overarching risk management policy. Within this framework, each policy governs a particular risk type (e.g. insurance risk and market risk) and is supported by a range of minimum standards, which detail the minimum level of compliance required and the behaviours expected. The Group employs a range of other processes as part of its enterprise-wide risk management framework covering areas such as key risk indicators, stress testing and scenario analysis, issue management, event and loss data management and business continuity management.

Risk appetite and strategy

The Group's risk appetite framework is reviewed and approved by the Board, taking into account the business strategy and risk strategy. It incorporates a series of strategic risk appetite statements assigned to the strategic risk objectives, which form the framework around the Group's overall risk appetite objectives and cover all principal risk types. These risk appetite statements cover the Group as a whole as well as individual business areas.

The Board's appetite is predominantly for general insurance risk, with other exposure being consequential to this, as required for the Group to undertake its primary activity. The oversight and management of insurance risk is, therefore, a key responsibility of the Board and its associated committees.

Insurance risk management

As the largest risk to which the business is exposed, the oversight, management and control of insurance risk is considered of strategic importance to the Group. As such, the Group has a range of functions, processes and controls in place to manage insurance risk across the Group, such as:

- ***pricing and underwriting functions:*** responsible for setting, developing and monitoring the pricing and underwriting strategy; setting annually reviewable personal underwriting authorities and limits, where appropriate; developing and implementing product underwriting manuals; defining policy terms and conditions; setting prices for the majority of business underwritten; and ensuring at all times that the businesses operate within the Board approved risk appetite;

- ***claims function:*** responsible for the implementation and management of appropriate claims policies and procedures, including personal reserving and payment authorities where appropriate; appropriate, timely and cost effective handling and settlement of claims; developing and monitoring relevant, current management information to enable the identification of potential and emerging claims trends that could impact claims management, costs and/or reserving processes; and interacting with relevant functions to ensure the detailed understanding of claims development patterns to assist in overall pricing and reserving processes;
- ***reserving function:*** responsible for determining the actuarial best estimate reserves for each product based on a range of data and other information, including assessing the uncertainty in these estimates to help the Board determine the management best estimate; and ensuring all elements are documented in accordance with required records management procedures and professional guidance; and
- ***reinsurance function:*** responsible for the oversight and management of existing reinsurance contracts; and recommending the purchase of and overseeing the implementation and performance of future UK reinsurance contracts.

Solvency II

The Group has an established Group-wide Solvency II programme with the aim of ensuring that the Group implements the required changes in a timely and appropriate manner, including achieving internal model approval for the main UK regulated general insurance entity. Changes required to bring the Group into full compliance remain ongoing and in the period prior to implementation of Solvency II, the Group intends to further develop its internal model, both in terms of scope and area of use. In addition to an enhanced risk based assessment of the capital requirement, the programme is intended to provide improved risk management by more consistently taking the risk and capital effects into consideration in strategic and operational decision making. The range and nature of items requiring regular Board or risk and audit committee review and approval in relation to the internal model will also increase, such as the need to review and approve the Group's own risk and solvency assessment.

INTELLECTUAL PROPERTY

The Group is the owner of, amongst others, trademarks for Churchill, Direct Line, Direct Line for Business, Privilege, and Green Flag. These trademarks are established, registered and well known in the United Kingdom through their extensive use. The trademarks Direct Line and Green Flag are also registered and in use in Germany and Italy. The Group has obtained EU Community Trade marks for, amongst others, the Direct Line, Churchill and Green Flag trademarks. In certain other territories outside the United Kingdom and European Union, trademarks have been registered, or applications have been filed and are under examination. These registrations and applications have been made in areas where the Group may want to establish business under one of its existing brands in the future.

The Group is the owner of approximately 280 domain names. The RBS Group is the owner of approximately 370 other domain names which are used by the Group. These domain names include "churchill.com", "directline.com", "directlineforbusiness.co.uk", "privilege.com" and "greenflag.com", through which the Group conducts much of its online business. The RBS Group will assign the domain names owned by the RBS Group which are used by the Group on or prior to separation from the RBS Group.

INFORMATION TECHNOLOGY

The Group's UK Business Technology Services ("**BTS**") function shapes, builds, runs and governs the information technology ("**IT**") for the Group's UK operations. The BTS function is organised into five functions: strategy & architecture; solutions & delivery; infrastructure services; development services & IT service delivery; and support office. The Group has also developed strategic supplier relationships with both HCL Technology Limited and Cap Gemini, which provide additional application development, maintenance and testing support.

The BTS function oversees the Group's UK insurance IT application portfolio and develops a majority of the application designs, code and support, including configuration management, release, implementation and testing. RBS Group technology services currently provides the data centre services and builds and supports all of the Group's IT infrastructure including servers, networks, desktops and telephony. In addition, the Group runs and services separate IT systems for its Italian and German businesses (and for which the RBS Group also provides certain IT infrastructure services), leveraging the knowledge and experience of its UK operations and BTS function.

The Group runs the applications that cover the sales and service processes, internet back end processing, customer documents, pricing and underwriting, claims, complaints, accounting and management information for most of its products, and is currently in the process of improving the capabilities of many of these platforms, particularly for claims handling, pricing and rating. The Group is also making investments in IT infrastructure, such as an upgrade to its UK call centre technology, which the Group believes will enable more sophisticated call routing, integrated telephony management and improvements to its information security processes.

During the TSA period, the Group will continue to rely on the RBS Group for the provision of data centre and certain other IT infrastructure services under the terms of the TSA. The Group intends to identify third party suppliers to which these data centres and other IT infrastructure services would migrate by the end of the TSA period. The Group will be making a significant investment in its own IT both to prepare for and execute that migration, and expects to incur one-off costs in the region of £100 million, before any applicable tax deduction, over the next two to three years. This amount, which may be capitalised in part, does not include additional operating costs to be incurred under the TSA.

DIRECTORS

The following is a list of the directors of the Issuer and their principal directorships, if any (other than the positions with the Issuer) which are or may be significant with respect to the Issuer as at the date of this document. The business address of each of the directors is Churchill Court, Westmoreland Road, Bromley, Kent BR1 1DP, United Kingdom.

Name	Responsibilities in relation to the Issuer	Current other directorships
Andrew William Palmer	Non Executive Director	Royal London Mutual Insurance Society Limited The Royal School of Needlework RSN Enterprises Limited Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited U K Insurance Limited The National Insurance and Guarantee Corporation Limited Segro Public Limited Company
Jane Carolyn Hanson	Non Executive Director	The National Insurance and Guarantee Corporation Limited U K Insurance Limited Churchill Insurance Company Limited Direct Line Insurance Limited JCH Associates (UK) Limited Reclaim Fund Ltd Calderdale and Huddersfield Foundation Trust
Paul Robert Geddes	Chief Executive	Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited Direct Line Life Insurance Company Limited Indemnity Insurance Limited U K Insurance Limited The National Insurance and Guarantee Corporation Limited

Name	Responsibilities in relation to the Issuer	Current other directorships
Anthony Jonathan Reizenstein	Finance Director	Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited Direct Line Life Insurance Company Limited U K Insurance Limited The National Insurance and Guarantee Corporation Limited

Andrew William Palmer: Andrew joined the Board in March 2011. Andrew is also a senior independent director at Segro plc, the British and European Industrial REIT Company; a non executive director of the Royal School of Needlework and RSN Enterprises Limited; and a non executive director at Royal London Mutual Insurance Society Limited. In 2009 he retired from Legal & General Group plc, where he was the group finance director. He is a member of The Financial Reporting Review Panel, of the Financial Reporting Council. Andrew is a fellow of the Institute of Chartered Accountants in England & Wales.

Jane Carolyn Hanson: Jane joined the Board in December 2011. A fellow of the Institute of Chartered Accountants, Jane qualified with KPMG, where she spent over 12 years working in the financial sector practice, becoming director responsible for the delivery of corporate governance, internal audit and risk management services in the North of England. Jane has also held executive roles as director of audit, and risk and governance director at Aviva. Jane is chair of the audit and risk committee and non-executive director at The Reclaim Fund Ltd; an independent member of the fairness committee at ReAssure Ltd (formerly Admin Re); and chair of audit and risk committee and senior independent director at Calderdale and Huddersfield Foundation Trust. Jane has her own financial sector consulting business, delivering audit, enterprise risk management and corporate governance advisory and consulting services and is also a magistrate. Jane is a graduate of York University with a degree in music.

Paul Robert Geddes: Paul was appointed as Chief Executive of the Company in August 2009. Prior to his move to the Company, Paul was the chief executive officer of the RBS Group's mainland UK retail banking business, having joined that business in 2004 as managing director with responsibility for products and marketing. He remains a member of the RBS Group's executive committee. Before joining the RBS Group, Paul held a number of senior roles in multi-channel retailing in businesses then forming part of the GUS and Kingfisher groups. Paul started his career in marketing with Procter & Gamble in UK and European roles. Paul read politics, philosophy and economics at Oxford, graduating in 1990, and remains a supporter of his college through music scholarships. He is a fellow of the Chartered Institute of Bankers in Scotland, a member of the ABI Board, a member of the Financial Ombudsman Service's insurance industry steering group and a member of the FSA Practitioner Panel.

Anthony Jonathan Reizenstein: John joined as Finance Director in December 2010. He was previously managing director, corporate and markets at Co-operative Banking Group (CBG, the group bringing together The Co-operative Bank, Co-operative Insurance Society and CIS General Insurance) and finance director at CBG from 2003 to 2007. Prior to joining CBG, John spent more than 20 years in investment banking, with UBS and subsequently with Goldman Sachs. John is an economics graduate from Cambridge University and has been a member of the Financial Reporting Review Panel.

There are no potential conflicts of interest between the duties to the Issuer of the persons listed above and their private interests or other duties.

As announced on 23 March 2012, Mike Biggs is to be appointed as Chairman of the Group. Mike has almost 40 years of experience in the UK and international financial services sector. He is chairman of Resolution Limited, the FTSE 100 UK life assurance business, a role he will retain, and has previously acted as chief executive officer and group finance director of Resolution plc, and group finance director of Aviva plc. Mike was a key member of the senior management team that demutualised and subsequently floated Norwich Union on the London Stock Exchange in 1997, and merged Norwich Union with Commercial General Union to create CGNU in 2000.

Recruitment of additional non-executive board members is underway, in preparation for the Group's divestment from the RBS Group.

THE GUARANTOR

The Guarantor was incorporated on 6 August 1974 as a private limited company with registered number 01179980. The Guarantor operates under the Companies Act 2006. The registered office of the Guarantor is at The Wharf, Neville Street, Leeds LS1 4AZ, United Kingdom and its telephone number is +44 (0) 113 399 1461.

The Guarantor is a direct wholly-owned subsidiary of the Issuer. At the date of this document, the Issuer and Guarantor are wholly-owned subsidiaries of The Royal Bank of Scotland Group plc.

The Guarantor is the principal UK general insurance underwriter in the Group. It underwrites personal lines insurance including household, motor, motor recovery/breakdown, household recovery, private legal protection, creditor, travel and pet insurance. It also underwrites a wide range of commercial insurance for businesses sold directly and through brokers, targeting the small and medium sized enterprise market.

DIRECTORS

The following is a list of the directors of the Guarantor and their principal directorships, if any (other than their positions with the Guarantor) which are or may be significant with respect to the Guarantor as at the date of this document. The business address of each of the directors is Churchill Court, Westmoreland Road, Bromley, Kent BR1 1DP, United Kingdom.

Name	Responsibilities in relation to the Guarantor	Current other directorships
Andrew William Palmer	Non Executive Director	Royal London Mutual Insurance Society Limited The Royal School of Needlework RSN Enterprises Limited Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited Direct Line Insurance Group plc The National Insurance and Guarantee Corporation Limited Segro Public Limited Company
Jane Carolyn Hanson	Non Executive Director	The National Insurance and Guarantee Corporation Limited Direct Line Insurance Group plc Churchill Insurance Company Limited Direct Line Insurance Limited JCH Associates (UK) Limited Reclaim Fund Ltd Calderdale and Huddersfield Foundation Trust
Paul Robert Geddes	Chief Executive	Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited Direct Line Life Insurance Company Limited Indemnity Insurance Limited Direct Line Insurance Group plc The National Insurance and Guarantee Corporation Limited

Name	Responsibilities in relation to the Guarantor	Current other directorships
Anthony Jonathan Reizenstein	Finance Director	Churchill Insurance Company Limited Direct Line Group Limited Direct Line Insurance Limited Direct Line Life Insurance Company Limited Direct Line Insurance Group plc The National Insurance and Guarantee Corporation Limited

There are no potential conflicts of interest between the duties to the Guarantor of the persons listed above and their private interests or other duties.

REGULATORY OVERVIEW

The Group's insurance subsidiaries in the United Kingdom, Germany and Italy are subject to detailed and comprehensive legislation and regulation in each jurisdiction. Regulatory agencies have broad administrative powers over many aspects of the insurance business, which may include marketing and selling practices, advertising, licensing agents, product development structures, premium rates, policy forms, claims and complaint handling practices, data and records management, systems and controls, capital adequacy, and permitted investments.

The Group is subject to regulation and supervision by the FSA in relation to the carrying on of its regulated activities in the United Kingdom. In respect of its international operations, Direct Line Insurance S.p.A. ("**Direct Line Italy**") is subject to regulation and supervision by the *Instituto per la Vigilanza sulle Assicurazioni Private di Interesse Collettivo* ("**ISVAP**") and Direct Line Versicherung AG ("**Direct Line Germany**") is subject to regulation and supervision by the *Bundesanstalt für Finanzdienstleistungsaufsicht* ("**BaFin**"). All countries in which the Group carries out insurance business have implemented the EU directives concerning the taking up and pursuit of non-life insurance business. As a result, all of the Group's regulated entities are subject to capital requirements with a view to ensuring the protection of policyholders.

The following discussion considers the main features of the UK, Italian and German regulatory regimes for insurance business as it applies to the Group's authorised insurance companies in the United Kingdom, Direct Line Italy and Direct Line Germany, respectively.

Regulation in the United Kingdom

The FSA's powers

In the United Kingdom, the Group's business is currently subject to primary regulation by the FSA, which has broad powers under the FSMA, including, among others, the authority to: grant and, in specific circumstances, to vary or cancel permissions; ensure regulated firms treat customers fairly; investigate marketing, sales, claims and complaint handling practices; and require the maintenance of adequate financial resources. One of the FSA's principal regulatory objectives in the context of the regulation of insurance companies is the protection of policyholders and third party claimants, rather than shareholders or general creditors.

The FSA has powers to impose requirements on an insurance company (such as a requirement not to take on new business) if it is satisfied that the company has not met its capital adequacy requirement or does not meet the Threshold Conditions (as defined below in "*—Permission to carry on insurance business*"). The FSA may make enquiries or conduct inspections of the companies which it regulates regarding compliance with regulations governing the conduct and operation of business. Issues and disputes may arise from time to time in relation to the way an insurance product has been constructed, sold or administered, or in the way in which policyholders or customers have been treated, either at an individual firm level or across the insurance industry. In the United Kingdom, individual policyholder disputes of this nature are typically resolved by the Financial Ombudsman Service or by litigation. The FSA may intervene directly, however, where larger groups or matters of public policy are involved. There have been several industry-wide issues in recent years where the FSA intervened directly, such as the sale of payment protection insurance.

The FSA has wide powers to supervise and intervene in the affairs of an insurance company, for example, if it considers that it is appropriate in order to protect policyholders or potential policyholders against the risk that the company may be unable to meet its liabilities as they fall due, that the Threshold Conditions may not be met, that the company or its parent has failed to comply with obligations under the relevant legislation, that the company has furnished misleading or inaccurate information or that there has been a substantial departure from any proposal or forecast submitted to the FSA. The FSA also has the power to take a range of informal and formal disciplinary or enforcement actions in relation to a breach by a firm of FSMA or the rules in the FSA's Handbook, including private censure, public censure, restitution, fines or sanctions and the award of compensation. The FSA may also cancel or vary (including by imposing limitations on) a Part IV Permission (as defined below in "*—Permission to carry on insurance business*") of an insurance company, including cancelling permission to write new policies, thereby putting the insurer into run-off.

Permission to carry on insurance business

Under section 19 of the FSMA, it is unlawful to carry on insurance business in the United Kingdom without permission to do so from the FSA under Part IV of the FSMA (a "**Part IV Permission**").

The FSA, in deciding whether to grant a Part IV Permission, is required to determine whether the applicant satisfies, and will continue to satisfy, the FSMA Threshold Conditions (the "**Threshold Conditions**"). As part of this decision, the FSA will consider whether the applicant has adequate resources and if the applicant is 'fit and proper' to be authorised (that is, whether it has established systems and controls to comply with regulatory standards and the FSA's Principles for Business, which cover matters such as: integrity; skill, due care and diligence; management and control; financial prudence; observance of the proper standards of market conduct; payment of due regard to customers' interests and treating customers fairly; communication with clients; management of conflicts of interest; a proper relationship of trust with clients; adequate protection for clients' assets when responsible for them; and dealing with regulators in an open and cooperative way). A Part IV Permission will specify: (a) a description of the activities the firm can carry on, including any limitations to the scope of the permission; (b) the specified investments involved; and (c) if appropriate, any requirements imposed in relation to the Part IV Permission.

Once authorised, an insurance company is required to continue to meet the Threshold Conditions and comply with the FSA's Principles for Business. The FSA may impose limitations and requirements relating to the operation of an insurance company and the carrying on by it of insurance business through its Part IV Permissions.

Screening of controllers (including shareholders)

Under section 178 of FSMA, if a person intends to acquire or increase its "control" of an insurance company, it must first notify the FSA. The FSA must then decide whether to approve the acquisition or increase of control within 60 working days' of receipt of this notice (assuming it has been provided with a complete application). The FSA will not approve any new controller or any increase of control without being satisfied that the controller is financially sound and suitable to be a controller of, or acquire increased control of, the insurance company. Acquiring control for the purposes of FSMA includes where a person first holds 10 per cent. or more of the shares or voting power in an insurance company or its parent undertaking. A person will be treated as increasing his or her control over an insurance company, and therefore require further approval from the FSA, if the level of his or her shareholding or entitlement to voting power increases from a holding below certain thresholds to a holding above them. The thresholds are 10 per cent., 20 per cent., 30 per cent. or 50 per cent. of shares or voting power.

When determining a person's level of control, that person's holding of shares or entitlement to voting power will be aggregated with the holdings or entitlements of any person with whom he or she is "acting in concert".

Screening of controlled function holders

Certain key functions in the operation of an insurance business ("**controlled functions**") may only be carried out by persons who are approved for such tasks by the FSA under the FSMA ("**Approved Persons**").

Under FSMA, the FSA has powers to regulate two types of individuals: those whose functions have a significant influence on the conduct of an authorised company's affairs and functions and those who deal with customers (or the property of customers).

The 'significant influence' controlled functions include governing functions such as being a director or non-executive director of an insurance company, finance functions, actuarial functions and significant management functions, such as insurance underwriting. The FSA will not grant Approved Person status to an individual unless it is satisfied that the individual has appropriate qualifications and/or experience and is fit and proper to perform those functions.

Approved Persons must comply with the FSA's Fit and Proper Test for Approved Persons (as set out in the chapter of the FSA Handbook bearing such title) and the Statements of Principle and Code of Practice for Approved Persons (as set out in the chapter of the FSA Handbook bearing such title).

Prudential requirements

Detailed prudential rules applicable to carrying on insurance business are contained in the FSA's Handbook of Rules and Guidance (the "**FSA Handbook**"). The rules are set out in (i) its General Prudential Sourcebook ("**GENPRU**") and (ii) its Prudential Sourcebook for Insurers ("**INSPRU**"). The overall financial adequacy rule in GENPRU 1.2.26R requires an insurance company to maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

(a) Capital requirements

GENPRU 2.1.13R provides that an insurer must maintain at all times capital resources equal to or in excess of its capital resources requirement (referred to as the "**CRR**"). The CRR for an insurance company carrying on general (and not long-term) insurance business is equal to the minimum capital requirement ("**MCR**") (GENPRU 2.1.17R). The MCR for an insurance company only carrying on general insurance business is the higher of:

(i) the base capital resources requirement; and

(ii) the general insurance capital requirement.

The base capital resources requirement is a euro-denominated amount specified in GENPRU 2.1.30R and the general insurance capital requirement is an amount determined by reference to a formula where the relevant inputs include the insurance company's premiums and claims and amounts brought forward from the previous year's capital requirement amount.

(b) Individual Capital Assessment

In addition to the CRR, insurance companies carrying on general insurance business are each required to calculate an enhanced capital requirement (the "**ECR**") under INSPRU 1.1.72B and carry out an Individual Capital Assessment ("**ICA**") under INSPRU 7. Pursuant to the ICA, insurance companies are required to conduct stress and scenario testing to determine the overall adequacy of their financial resources and make a reasonable assessment of the capital needs for their business overall in line with the overall financial adequacy rule in GENPRU 1.2.26R.

The ICA and the ECR assists the FSA to provide Individual Capital Guidance ("**ICG**") to insurance companies on a confidential basis. The ICG is set with reference to the specific business and control risks faced by each individual company and takes account of the company's ICA and any areas of prudence or optimism within the assessment or elsewhere in the business.

Reporting

Insurance companies are required to deposit with the FSA an annual return comprising audited accounts and other prescribed documents within three months of the end of the relevant financial year, if the deposit is made electronically, and otherwise within two months and fifteen days of the end of the relevant financial year. These returns are required to be prepared in accordance with the valuation rules in INSPRU and GENPRU and the reporting rules in the Interim Prudential Sourcebook for Insurers.

Investment of capital and reserves

Under INSPRU 1.1.20R, insurance companies carrying on general insurance business must hold admissible assets of a value at least equal to the amount of:

(A) the technical provisions that it is required to establish under INSPRU 1.1.12R, being, in essence, an estimate of the amount needed to cover expected insurance claims, adjusted for volatility and prudence; and

(B) its other general insurance liabilities.

Assets and investments only count towards capital adequacy requirements if they are capable of being valued in accordance with GENPRU 1.3 and GENPRU 2 Annex 7R. Assets are also required to be deducted from capital resources if they do not comply with the requirements in INSPRU 2 as to counter-party and asset exposure limits (although they may still be included in the calculation of a firm's realistic assets). These limits are intended to prevent companies from having too much exposure to either one counterparty (including a group of companies) or one asset type.

Insurance group capital

The Directive on the Supplementary Supervision of Insurance Companies in an Insurance Group (1998/78/EC) (the "**Insurance Groups Directive**") as amended by the EU Directive on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate (2002/87/EC) requires Member States to provide supervision for any insurance undertaking that is part of a group which includes at least one other insurance company, insurance holding company, reinsurance undertaking or non-member-country insurance undertaking. The relevant provisions governing group capital for UK insurers are primarily contained in Chapter 6 of INSPRU.

The Group is an insurance group for the purposes of the Insurance Groups Directive and is therefore subject to the supplementary supervisory requirements for insurance groups contained in that directive as implemented by the FSA as the regulator in the domicile of the Group's head office. The supplementary supervision of insurance groups encompasses such matters as intra-group transactions, group risk management processes and internal control processes and reporting and accounting procedures. In addition, in accordance with the Insurance Groups Directive, the FSA requires the calculation of group capital resources on a consolidated basis and requires that such group capital resources are equal to or in excess of the Group's capital resources requirement. These requirements apply at the same time as, and in addition to, the capital requirements which apply to the Guarantor and the other insurance companies within the Group on a solo basis.

Conduct of business requirements

The FSA's conduct of business requirements in relation to the distribution and sale of insurance products are contained in its Insurance Conduct of Business Sourcebook ("**ICOBS**").

ICOBS applies to non-investment insurance products, including long term non-investment insurance products such as mortgage protection insurance. These sourcebooks also implement the Insurance Mediation Directive (Directive 2002/92/EC) ("**IMD**") and extend the IMD to direct sales by insurers themselves.

Many of the provisions of these sourcebooks only apply to insurers or intermediaries who deal directly with retail customers, or are confined in their application to transactions with retail customers. Further, the rules require the product documentation to be fully compliant for retail sales.

Regulation in Italy

The ISVAP is an independent government regulator with powers similar to the FSA, including authority over financial, accounting, organisational and management aspects of insurance, among others. The supervision exerted by ISVAP is aimed to ensure the sound and prudent management of insurance and reinsurance undertakings as well as transparency and fair conduct by undertakings, intermediaries and other insurance sector participants, having regard to the stability, efficiency, competitiveness and correct functioning of the insurance system, the protection of policyholders and anyone entitled to insurance benefits, disclosure to and protection of consumers.

ISVAP carries out supervisory functions over, among others:

- undertakings pursuing insurance and reinsurance business within Italy;
- insurance groups and financial conglomerates to which the above undertakings belong, in accordance with the specific rules applicable to them (the so-called "supplementary" supervision);
- insurance and reinsurance intermediaries, loss adjusters and any other insurance market participant; and
- anyone who, in any form, performs functions partly included in the operational cycle of insurance and reinsurance undertakings, limited to insurance and reinsurance matters.

ISVAP carries out supervisory functions over the insurance sector by means of its powers of authorisation, direction, inspection, specific investigation and enforcement of precautionary measures and sanctions as well as through the adoption of any regulation necessary for the sound and prudent management of undertakings or for disclosure and fair conduct by supervised entities.

In particular, ISVAP grants insurers the authorisation to pursue insurance and/or reinsurance business in the different classes and to extend their activity to classes other than those already authorised, and performs all the tasks connected with the granting of authorisation, verifying over time that the conditions governing the business are being met. It also authorises mergers, divisions, portfolio transfers and intra-group transactions. These tasks are performed through checks of the technical, financial and accounting management of the domestic and foreign insurance and reinsurance undertakings (branches of undertakings with their head office in a non-EU country) subject to its supervision.

ISVAP also plays a key role in consumer protection and seeks to ensure transparency between insurers and policyholders. ISVAP has the power to review, approve and mandate the information that must be made available to policyholders, establishes the rules of conduct with which insurers and intermediaries must comply in the supply and execution of insurance contracts and monitors compliance with those requirements.

Regulation in Germany

The Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* the "**BaFin**") supervises insurance and reinsurance undertakings and pension funds that have their registered office in Germany or carry out insurance business in Germany, insurance holding companies domiciled in Germany, and insurance groups and financial conglomerates, to which insurance and reinsurance undertakings domiciled in Germany belong. In addition, BaFin is in charge of regulating German branches of foreign insurance and reinsurance undertakings although, due to the European "home state regulator" principle, the BaFin's supervisory powers are somewhat limited (and do not include, for instance, any matters of financial supervision) if the relevant foreign insurance or reinsurance undertaking is domiciled in another EU/EEA jurisdiction.

The BaFin is an independent public-law institution under federal law and is subject to the legal and technical oversight of the Federal Ministry of Finance (*Bundesministerium der Finanzen*, the "**BMF**"). It is funded by fees and contributions from the insurance and reinsurance undertakings that it supervises.

The principal legal basis for BaFin's powers in the insurance sector is the Insurance Supervision Act (*Versicherungsaufsichtsgesetz*, the "**VAG**"). Pursuant to VAG, the two primary objectives of insurance supervision are to ensure that the interests of the insurance customers are adequately preserved and that the liabilities under insurance contracts will be fulfilled at all times.

Insurance supervision by the BaFin is based on two main pillars. On the one hand, insurance business may not be carried out in Germany unless and until the undertaking has received an authorisation from the BaFin (apart from passporting rights of insurance and reinsurance undertakings domiciled in another EU/EEA state). On the other hand, the BaFin monitors all undertakings carrying out insurance or reinsurance business in Germany on an ongoing basis for compliance with the relevant laws.

Business activities of insurance undertakings are limited to defined classes of insurance business. Any authorization to carry out insurance business is granted only upon evidence that the undertaking complies with statutory and regulatory provisions, in particular with respect to the minimum solvency requirements and the minimum requirements to risk management and good governance including the qualification and reliability of the members of the management board and the supervisory board.

In its ongoing supervision, the BaFin collects information (including changes relating to the business plan, information on the performance and standing of the respective undertaking, and others), evaluates it and observes the way in which the insurance undertakings conduct their business, in order to avoid undesirable developments or to identify any such development in good time. The BaFin obtains key information via the insurance undertakings' external and internal financial reporting as well as extensive notification duties. At certain intervals or as required, BaFin also conducts reviews of an undertaking's situation by way of on-site inspections at the respective undertaking's offices. Moreover, transfers of insurance portfolios and any kind of transformation (*Umwandlung*) that involves insurance undertakings require prior authorization by the BaFin. A company intending to hold at least 10% of the capital/voting rights in a German insurance undertaking must notify the BaFin, which is entitled to prohibit the acquisition within a period of 60 business days. An acquisition of a German insurance undertaking could, *inter alia*, be prohibited when evidence suggests that the acquirer's management is not trustworthy or the acquirer does not have the required "financial solidity". Moreover, the holder of such significant interest (or participation) shall immediately notify the BaFin of any intention to increase the amount of the interest (or participation) to the extent that the thresholds of 20%, 30% or 50% of the voting rights/nominal capital are reached or exceeded. Shareholders also have to notify BaFin of their intention to sell a significant participation.

The BaFin has various means of taking action against insurance undertakings. Under the rules of the VAG, the BaFin may issue any instructions that are appropriate and necessary in order to prevent or eliminate undesirable developments with respect to insurance undertakings—in particular the failure to comply with the statutory and regulatory requirements—that threaten to harm the interests of the insurance customers. In addition, the VAG confers a number of special powers to the BaFin in order to avert certain typical threats to the functioning of an insurance undertaking, such as the power to appoint a special commissioner to replace the management board or the supervisory board of the company. The BaFin can revoke an undertaking's licence.

The BMF may empower the BaFin to issue regulatory ordinances wherever an enabling clause of the VAG provides for such possibility. However, the Insurance Contract Law (*Versicherungs-vertragsgesetz*, the "**VVG**") and the ordinances issued to substantiate certain aspects of the VVG fall outside the primary scope of the BaFin's competence. The BaFin may however intervene in case of severe infringements of the VVG or regulatory ordinances issued based on the VVG.

Unlike insurance undertakings, insurance intermediaries are subject to direct supervision by the respective competent local German Chamber of Industry and Commerce (*Industrie- und Handelskammer*, "**IHK**") whereas the BaFin supervises insurance mediation only indirectly and only insofar as the insurance mediations interferes with the good governance of the respective insurance undertakings. An IHK is a public statutory body under state law with self-administration under the supervision of the respective State Ministry of Economics. The principal provisions with respect to insurance mediation are set out in the Trade Regulation Act (*Gewerbeordnung*, the "**GewO**"). Pursuant to the GewO, insurance intermediation requires prior authorization by the competent IHK and is subject to ongoing supervision.

Anti-money laundering, anti-terrorism and sanctions laws and regulations

In addition to financial and insurance regulation, the Group must comply with anti-money laundering, anti-terrorism and sanctions laws and regulations. The Group is committed to work with international organisations, governments, law enforcement agencies, regulators and its industry peers to identify the threat of money laundering and close off channels in the financial system that money launderers, terrorists and other criminals may use.

Sanctions screening requires the Group to ensure it neither breaches legal and/or regulatory requirements nor suffers reputational damage by providing services to, or dealing directly or indirectly with persons, entities or countries who have been identified by the United Kingdom, United States, United Nations, European Union or other governmental, national and international bodies as subject to any form of restriction including financial sanctions or asset freezing orders.

The Group, like many other financial institutions, has come under greater regulatory scrutiny in recent years and expects that environment to continue for the foreseeable future, particularly as it relates to compliance with new and existing corporate governance, employee compensation, conduct of business, anti-money laundering and anti-terrorism laws and regulations, as well as the provisions of applicable sanctions programmes. Regulatory investigations and/or enforcement actions against the Group in relation to anti-money laundering, anti-terrorism and sanctions laws or regulations could result in fines, immediate reputational and regulatory risks, and materially adversely impact its business, results of operations and financial position. The Group is currently reviewing its policies, processes and practices in relation to anti-money laundering and sanctions screening, and is in dialogue with the relevant UK authorities regarding this programme. The aim of the programme is to replace the Group's current sanctions screening processes with a fully compliant automated process by July 2012. This process and dialogue is aligned with that currently being undertaken by the RBS Group.

Regulatory developments

The insurance industry faces a number of regulatory initiatives aimed at addressing lessons learned from the financial crisis and other industry-level issues such as payment protection insurance mis-selling.

These initiatives include new prudential rules on capital adequacy frameworks, new conduct rules and new applications for those rules, and other changes as a result of regulatory investigations and actions. In addition, new UK regulatory bodies are in the process of being established and the proposals on how they will operate are still to be approved by the UK Parliament.

Structural reform of the UK financial supervisory architecture

The UK government is in the process of implementing its reform of the framework for financial regulation in the United Kingdom and the Financial Services Bill relating to these reforms was introduced in Parliament on 26 January 2012. The Financial Services Bill provides for the dual supervision of UK insurance companies by two new regulators: the Prudential Regulation Authority (the "**PRA**") and the Financial Conduct Authority (the "**FCA**"). The PRA will be a subsidiary of the Bank of England with responsibility for promoting the stable and prudent operation of the financial system through the regulation of all deposit-taking institutions, insurers and investment banks, and the FCA will be responsible for regulating conduct in retail and wholesale financial markets and the infrastructure that supports those markets. In addition, the Financial Services Bill provides for specific additional powers for the PRA and the FCA, including:

(1) the ability for the FCA to intervene in order to ban financial products from sale or to ban a firm from selling a widely accepted product if it determines such firm's sale processes to be unacceptable; and

(2) the ability for the PRA to direct an unregulated holding company to take a particular action, or refrain from taking a particular action, and to censure or fine such company if it does not so comply.

The new regulatory bodies are in the process of being established and the proposals on how they will operate are still to be approved by the UK Parliament. The Group's UK insurance subsidiaries will be regulated by both the PRA and the FCA, and there are risks and uncertainties as to how the two bodies will interact with each other over the regulation of the same legal entities. While the Group will seek to ensure that it is prepared for this new system of regulation, there are risks associated with the uncertainty in respect of how the new regulators intend to apply their new powers and whether the new system will result in more intrusive and intensive regulation, adding additional burdens on the Group's resources. For instance, it is unclear how the FCA intends to apply its powers in respect of sale of financial products, and if there is any change in regulatory focus in the United Kingdom on product regulation, it may also impact the Group's ability to sell certain products in the future, which may adversely affect the Group's partnership arrangements.

The UK government's stated aim is for the Financial Services Bill to gain Royal Assent by the end of 2012 and the new regulatory framework to be operational in early 2013.

The new EU solvency regime for insurance companies

The European Commission is continuing to develop a new prudential framework for insurance companies, known as the "Solvency II" project, that will replace the existing life, non-life, re-insurance and insurance groups directives. The main aim of this framework is to ensure the financial stability of the insurance industry and protect policyholders through establishing solvency requirements better matched to the true risks of the business. Solvency II adopts a three-pillar approach to prudential regulation which is similar to the "Basel II" approach which has already been adopted in the banking sector in Europe. These pillars are quantitative requirements (Pillar 1); qualitative requirements (Pillar 2); and supervisory and reporting disclosure (Pillar 3).

Although the Solvency II directive has similarities to the current UK regime set out in GENPRU and INSPRU in terms of its risk-based approach to the calculation of capital resources requirements and use of capital tiering, there are also many differences both in terms of substance and terminology.

A key aspect of Solvency II is the focus on a supervisory review at the level of the individual legal entity. Insurers will be allowed to make use of internal economic capital models to calculate capital requirements if the model has been approved by the regulator. In addition, Solvency II requires firms to develop and embed an effective risk management and internal audit system as a fundamental part of running the firm.

Solvency II is being developed in accordance with the Lamfalussy four-level process. The "Level 1" directive was formally approved by the European Parliament on 22 April 2009 and the final text was adopted by the European Council on 10 November 2009 and sets out a framework which will be supplemented by further and more detailed technical implementing measures at "Level 2". At "Level 3" non-binding standards and guidance will be agreed between national supervisors and at "Level 4" the European Commission will monitor compliance by Member States and take enforcement action as necessary. Proposed modifications to the Level 1 directive (set out in a legislative proposal from the European Commission in January 2011 referred to as the Omnibus II directive ("**Omnibus II**")) are likely to mean that, in addition, binding technical standards will be produced at "Level 2". At present, it is expected that each Member State will be required to implement the new rules by 1 January 2013, with the regime becoming binding on insurers and reinsurers within each Member State from 1 January 2014. However, uncertainty still remains as to whether there will be further legislative delays which will cause these timelines to be pushed to later dates.

Solvency II provides for the supervision of insurance groups and will impose a group-level capital requirement in relation to certain insurance groups, including the Group. Where entities in any insurance group are located in different Member States, the national supervisors of those entities will participate in a college of supervisors to supervise the group, with the FSA becoming the lead regulator for the Group as the regulator in the domicile of the Group's head office.

The Group's Solvency II programme is scheduled to meet implementation requirements and milestones (see "*Description of the Business of the Issuer and the Group—Capital Resources—Solvency II*" and "*Description of the Business of the Issuer and the Group—Risk management*"). However, the implementation of this programme, and the ultimate changes required to the Group's capital involve certain risks (see "*Risk Factors—Risks relating to the Group—The European Union is currently in the process of introducing a new regime governing solvency requirements, technical reserves, and other requirements for insurance companies, the effect of which is uncertain*").

The European Insurance and Occupational Pensions Authority

The European Parliament has called for a strengthening of the European supervision framework to reduce the risk and severity of future financial crises. This has led to the creation of the European Insurance and Occupational Pensions Authority ("**EIOPA**"), which is a regulatory and supervisory authority which replaces the Committee of European Occupational Pensions Supervisors. EIOPA is part of the European System of Financial Supervisors that comprises three supervisory authorities: one for the banking sector, one for the securities sector and EIOPA for the insurance and occupational pensions sector. Under Omnibus II, EIOPA will have extended powers to develop the detailed aspects of the Solvency II regime, to provide guidelines and recommendations to national supervisors and to resolve differences between national supervisors in the supervision of international insurance groups. The Group will seek to ensure that it is prepared for regulation under the EIOPA, however there are risks associated with the uncertainty in respect of how the EIOPA intends to apply its powers and whether the new authority will result in more intrusive and intensive regulation, adding additional burdens on the Group's resources.

Payment Protection Insurance mis-selling complaints

The FSA has restricted the sales practice for creditor insurance, also known as Payment Protection Insurance ("**PPI**"), which covers the payments under financial products if the borrower is unable to make the payments due to accident, sickness, unemployment or death, and has been sold alongside unsecured or secured personal loans, credit cards and mortgages. New FSA rules took effect from December 2010 and clarified the standards that firms selling PPI should have met when explaining to potential customers the key features and exclusions of the policies. Increasing numbers of customers are now claiming a refund of premiums for PPI cover which they claim was mis-sold. The Group has underwritten a significant amount of PPI business. The majority of this exposure related to policies originally underwritten by U K Insurance, which were sold in branches, online or via telephone by companies in the RBS Group's retail division. The RBS Group and the Group have agreed that responsibility for sums paid or payable to persons making PPI mis-selling complaints belongs to the RBS Group. Consequently, the Group is not expecting to be subject to the financial costs or administrative burden relating to such mis-selling complaints. The remainder of PPI business underwritten by the Group that is not subject to that agreement relates to business where the policies were generally sold by third parties, with most of this PPI business relating to schemes which were put into run off several years ago, and the Company believes that the Group's exposure to PPI mis-selling claims is not material.

Market study into motor insurance by the Office of Fair Trading

The Office of Fair Trading (the "**OFT**"), together with the UK Competition Commission, enforces consumer protection laws, including those relating to price fixing, collusion and other anti-competitive behaviour in the United Kingdom. There have been several market studies and investigations on the insurance industry in recent years. For example, on 14 December 2011, the OFT launched a market study into the supply of private motor insurance in the United Kingdom, with a focus on third party vehicle repairs and credit hire replacement vehicles to claimants. This followed the completion of a three month call for evidence on the market which indicated an increase in private motor insurance premiums paid in the United Kingdom. The OFT has indicated that it expects to complete its market study by Spring 2012. There are a number of possible outcomes of such market study, including enforcement action by the OFT, recommendations for changes in the law by the OFT or a referral by the OFT of the selling and pricing of motor insurance to the UK Competition Commission, which would have the power to enforce significant reforms. At this stage, the Group cannot estimate with any certainty the effect the market study and any related developments may have on it, including the timing of those effects. Any failure by the Group to comply with anti-competition regulations in any jurisdiction in which it carries on business could result in regulatory sanction and reputational damage, and materially adversely impact its business, results of operations and financial position.

Gender neutrality regulation

As a result of a ruling by the Court of Justice of the European Union (the "**ECJ**") in March 2011 prohibiting new contracts concluded from 21 December 2012 from using gender-based factors in the calculation of individuals' premiums and benefits, Member States are to amend their existing national laws to require insurance pricing to be gender neutral by such date. The UK government is currently proposing to amend the UK Equality Act 2010 to implement the ECJ ruling from 21 December 2012. The ruling will require similar changes to the laws of Italy and Germany. These changes pose risks for the Group and insurance industry generally, and will require the Group to adjust pricing structures and claims handling processes, including to limit the risk of anti-selection. While the Group's size and extensive customer data should aid its assessment of the required changes, significant adjustments to the Group's pricing and claims handling processes could have unexpected or unintended consequence on the mix of business or pricing strength of the policies written.

Civil litigation costs reform in England and Wales

As part of a growing movement toward civil litigation costs reform in England and Wales, a number of different initiatives have been discussed or proposed recently, any of which could have a significant impact on the UK insurance industry and on the Group. The most important of these include:

- ***Lord Justice Jackson's Final Report:*** As part of an ongoing government initiative to reform the civil litigation system in England and Wales, Lord Justice Jackson ("**Jackson LJ**") completed a detailed final report on costs in the English civil litigation system in January 2010 in which he recommended a number of specific changes. In March 2011, the government announced that it intends to implement most of Jackson LJ's primary recommendations, including the abolition of recoverable conditional fee agreements ("**CFA**"), success fees and after the event ("**ATE**") insurance premiums.
- ***Legal Aid, Sentencing and Punishment of Offenders Bill 2010/11:*** In June 2011 the government revealed its proposals for implementing many of Jackson LJ's primary recommendations in the Legal Aid, Sentencing and Punishment of Offenders Bill 2010/11. Significant provisions include, among others:

(i) Abolishing the recoverability of CFA success fees and ATE insurance premiums from a losing party (with certain exceptions). Instead success fees and ATE insurance premiums are to be paid by the party funded that way with the intended result of giving that party an incentive to control costs incurred on their behalf. The success fees are to be subject to a maximum limit and the government has said that it intends to retain the limit of 100% of base costs, except in personal injury cases, in which success fees will be subject to a 25% cap on damages (excluding for future care and loss).

(ii) Permitting the use of contingency fee or damaged based agreements ("**DBAs**") in civil litigation. The fees of a DBA funded lawyer relate to the damages awarded rather than the work done by the lawyer. Successful claimants funded by a DBA will be able to recover their base costs (i.e. lawyer's hourly rate fee and disbursements) from defendants in the usual way with the claimant being able to make up from the defendant any shortfall in the DBA fee the claimant owes its lawyer. DBAs are intended to be subject to similar requirements as for CFAs (e.g. the amount of payment that lawyers can take from damages in personal injury cases will be capped at 25% of damages excluding future care and loss).

The Bill is not yet in final form and is expected to come into force in April 2013.

- ***Government ban on referral fees:*** In September 2011, the Ministry of Justice announced plans to abolish referral fees in personal injury cases (e.g. referral fees paid to insurers for referring accident victims' details to third parties in personal injury cases). This is in line with Jackson LJ's recommendations in his final report. The ban is currently expected to take effect from April 2013.
- ***Governments court reforms:*** In February 2012, the Ministry of Justice announced that it intends to take forward a number of measures to prevent cost escalation in county courts. These include: (i) plans to extend the system of fixed recoverable cost to include higher value and a broader range of personal injury claims with the detail being finalised after consultation with key stakeholders; and (ii) plans to increase the small claims ceiling initially to £10,000 and, after evaluating this initial increase, £15,000. There will be no change to the current limit for personal injury and housing disrepair.
- ***House of Commons Transport Committee:*** The House of Commons Transport Committee published the Twelfth Report of Session 2010-12 in January 2012, containing a range of recommendations in relation to banning all referral fees, pre-action protocol, whether the legal fees for low value claims are reasonable, potential proposals on compensation in respect of whiplash claims, and a call for increased awareness within the insurance industry with respect to its compliance with data protection legislation.

UK insurance contract law

In 2006, the Law Commissions of England and Wales and for Scotland (the "**Law Commissions**") began a programme for the review of English and Scottish law. In December 2009 the Law Commissions published a joint report and draft bill introducing changes which affect insurance customer obligations regarding their disclosure of pre-contractual information to insurers and insurers' remedies where the consumers fail to do so. The main change introduced by the proposed legislation is to replace the duty of disclosure with a duty to take care to answer insurers' questions fully and accurately. This bill is expected to come into force during 2013, and is expected to bring the legal regime more in line with the regulatory regime that applies to insurers and consumers by the FSA and the decisions of Financial Ombudsman Service.

A consultation was also begun in December 2011 regarding the post contract regime applying between insurers and consumers with the expectation that this will lead to further legislation on such issues as a proposed duty to be placed upon the insurers to pay claims promptly (breach of which would lead to an obligation to pay damages to the insurance customer) and the consequences which flow from fraudulent claims. It is intended that these proposals will apply to insurance customers. Further consultations are expected during 2012 which will focus on business insurance customers both regarding pre- and post contract matters and are expected to permit the insurer greater freedom to contract out of the more onerous duties.

The proposals and legislation remain under debate and are not fixed. Pressure may also develop from proposals under discussion in the European Union and in the context of a European initiative known as the Principles of European Insurance Contract Law, which, if they are taken forward, may increase protection for consumer and business insurance customers yet further.

TAXATION

The following discussion is a summary of the current taxation treatment of payments of interest on the Notes under tax law in the United Kingdom. The discussion does not purport to be a comprehensive description of all tax considerations which may be relevant to a decision to purchase the Notes. The discussion is based on the tax laws of the United Kingdom and the published practice of HM Revenue & Customs as in effect on the date of this document, which are subject to change, possibly with retroactive effect. The discussion does not consider any specific facts or circumstances that may apply to a particular Noteholder and applies only to persons who are absolute beneficial owners of their Notes and may not apply to certain classes of persons such as dealers, certain professional investors or persons connected with the Issuer, to whom special rules may apply. The discussion does not necessarily apply where the income is deemed for tax purposes to be the income of any other person. The UK tax treatment of prospective Noteholders depends on their individual circumstances and may be subject to change in the future. Prospective Noteholders who may be unsure as to their tax position or who may be subject to tax in a jurisdiction other than the United Kingdom should seek their own professional advice.

UK Taxation

Payments of interest on the Notes may be made without withholding or deduction for or on account of UK income tax provided that the Notes continue to be listed on a "recognised stock exchange" within the meaning of section 1005 of the Income Tax Act 2007. The London Stock Exchange is a recognised stock exchange for these purposes. Securities will be treated as listed on the London Stock Exchange if they are included in the Official List (within the meaning of and in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000) and are admitted to trading on the London Stock Exchange. Provided therefore, that the Notes remain so listed, interest on the Notes will be payable without withholding or deduction on account of UK tax.

Interest on the Notes may also be paid without withholding or deduction on account of UK tax where interest on the Notes is paid by a company and, at the time the payment is made, the Issuer reasonably believes (and any person by or through whom interest on the Notes is paid reasonably believes) that the beneficial owner is within the charge to UK corporation tax as regards the payment of interest, provided that HM Revenue & Customs ("**HMRC**") has not given a direction (in circumstances where it has reasonable grounds to believe that it is likely that the above exemption is not available in respect of such payment of interest at the time the payment is made) that the interest should be paid under deduction of tax.

In other cases, an amount must generally be withheld from payments of interest on the Notes on account of UK income tax at the basic rate (currently 20%). However, where an applicable double tax treaty provides for a lower rate of withholding tax (or for no tax to be withheld) in relation to a Noteholder, HMRC can issue a notice to the Issuer to pay interest to the Noteholder without deduction of tax (or for interest to be paid with tax deducted at the rate provided for in the relevant double tax treaty).

Noteholders may wish to note that, in certain circumstances, HMRC has the power to obtain information (including the name and address of the beneficial owner of the interest) from any person in the United Kingdom who either pays or credits interest to or receives interest for the benefit of another person who is an individual. Information so obtained may, in certain circumstances, be exchanged by HMRC with the tax authorities of the jurisdiction in which the Noteholder is resident for tax purposes.

Interest on the Notes constitutes UK source income for tax purposes and, as such, may be subject to income tax by direct assessment even where paid without withholding.

However, interest with a UK source received without deduction or withholding on account of UK tax will not be chargeable to UK tax in the hands of a Noteholder (other than certain trustees) who is not resident for tax purposes in the United Kingdom unless that Noteholder carries on a trade, profession or vocation in the United Kingdom through a UK branch or agency in connection with which the interest is received or to which the Notes are attributable (and where that Noteholder is a company, unless that Noteholder carries on a trade in the United Kingdom through a permanent establishment in connection with which the interest is received or to which the Notes are attributable). There are exemptions for interest received by certain categories of agent (such as some brokers and investment managers). The provisions of an applicable double taxation treaty may also be relevant for such Noteholders.

In general, Noteholders which are within the charge to UK corporation tax will be charged to tax as income on all returns, profits or gains on, and fluctuations in value of, the Notes (whether attributable to currency fluctuations or otherwise) broadly in accordance with their statutory accounting treatment.

Noteholders should be aware that the provisions relating to additional payments referred to in Condition 9 of the Conditions would not apply if HMRC sought to assess the person entitled to the relevant interest on any Notes directly to UK income tax.

Payments in respect of the Guarantee

If the Guarantor makes any payments in respect of interest on the Notes (or other amounts due under the Notes other than the repayment of amounts subscribed for the Notes), such payments may be subject to UK withholding tax at the basic rate, subject to the availability of other reliefs or to any direction to the contrary from HMRC in respect of such relief as may be available pursuant to the provisions of any applicable double taxation treaty.

EU Directive on the Taxation of Savings Income

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State or certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (subject to a procedure whereby, on meeting certain conditions, the beneficial owner of the interest or other income may request that no tax be withheld), the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries. A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

The European Commission has proposed certain amendments to Directive 2003/48/EC, which may, if implemented, amend or broaden the scope of the requirements described above.

SUBSCRIPTION AND SALE

Citigroup Global Markets Limited, HSBC Bank plc and The Royal Bank of Scotland plc (the "**Managers**") have, pursuant to a subscription agreement dated 25 April 2012 (the "**Subscription Agreement**"), jointly and severally agreed with the Issuer to subscribe and pay for the Notes at 99.200 per cent. of the principal amount of the Notes and will receive certain commissions and expenses as agreed with the Issuer.

The Managers are entitled to terminate the Subscription Agreement in certain circumstances prior to payment to the Issuer.

United States

The Notes and the Guarantee in respect thereof have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act ("**Regulation S**").

Each Manager has agreed that, except as permitted by the relevant Subscription Agreement, it will not offer, sell or deliver the Notes and the Guarantee in respect thereof (i) as part of their distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the closing date, within the United States or to, or for the account or benefit of, U.S. persons, and it will have sent to each dealer to which it sells Notes and the Guarantee in respect thereof during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Notes and the Guarantee in respect thereof within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S.

In addition, until 40 days after the commencement of the offering of the Notes and the Guarantee in respect thereof, an offer or sale of Notes and the Guarantee in respect thereof within the United States by any Manager, whether or not participating in the offering, may violate the registration requirements of the Securities Act.

United Kingdom

Each Manager has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000 ("**FSMA**")) received by it in connection with the issue or sale of any Notes in circumstances in which section 21(1) of the FSMA does not or, in the case of the Guarantor, would not, if it was not an authorised person, apply to the Issuer or the Guarantor; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

General

Each Manager has agreed to comply with all applicable laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers the Notes or possesses or distributes this Prospectus or any other offering material relating to the Notes and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of the Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and none of the Issuer, the Guarantor and any other Manager shall have responsibility therefor.

None of the Issuer, the Guarantor, the Managers and the Trustee represents that Notes may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale.

Managers' business relationships with the Group

Each Manager and its affiliates may currently provide, and may continue to provide, banking services, including senior lending facilities, to the Issuer and Guarantor on customary market terms, and for which they have been or will be paid customary fees.

In addition, in the ordinary course of their business activities, each Manager and its affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of the Issuer, the Guarantor and/or their respective affiliates. Certain of the Managers or their affiliates that have a lending relationship with the Issuer, the Guarantor and/or their respective affiliates and may routinely hedge their credit exposure to the Issuer, the Guarantor and/or such affiliates consistent with their customary risk management policies. Typically, such Managers and their affiliates would hedge such exposure by entering into transactions which consist of either the purchase of credit default swaps or the creation of short positions in the securities of the Issuer, the Guarantor or the relevant affiliate, including potentially the Notes. Any such short positions could adversely affect future trading prices of the Notes. The Managers and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

GENERAL INFORMATION

1. The listing of the Notes on the Official List will be expressed as a percentage of their nominal amount (exclusive of accrued interest). It is expected that listing of the Notes on the Official List and admission of the Notes to trading on the Market will be granted on or around the Issue Date, subject only to the issue of the Global Certificate. Prior to official listing and admission to trading, however, dealings will be permitted by the London Stock Exchange in accordance with its rules. Transactions will normally be effected for delivery on the third working day after the day of the transaction.

2. Each of the Issuer and the Guarantor (as applicable) has obtained all necessary consents, approvals and authorisations in the United Kingdom in connection with the issue and performance of the Notes and the guarantee relating to the Notes. The issue of the Notes was authorised by a resolution of the Board of Directors of the Issuer passed on 26 March 2012 and by resolutions of a duly authorised Committee appointed by the Board passed on 10 April 2012 and 23 April 2012 and the giving of the guarantee relating to the Notes by the Guarantor was authorised by a resolution of the Board of Directors of the Guarantor passed on 26 March 2012 and by resolutions of a duly authorised Committee appointed by the Board passed on 10 April 2012 and 23 April 2012.

3. There has been no material adverse change in the prospects of the Issuer, the Guarantor or the Group since 31 December 2011. There have been no significant changes in the financial or trading position of the Group since 31 December 2011.

4. There are no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Issuer is aware) during the 12 months preceding the date of this Prospectus which may have, or have had in the recent past, significant effects on the Issuer's and/or the Group's financial position or profitability.

5. The Issuer estimates that the expenses in connection with the admission to trading of the Notes are expected to be £8,610.

6. The initial yield on the Notes will be 9.375 per cent. per annum calculated on a semi-annual basis. The yield is calculated on the Issue Date on the basis of the issue price of the Notes. It is not an indication of future yield.

7. The Notes have been accepted for clearance through the Euroclear and Clearstream, Luxembourg systems (which are the entities in charge of keeping the records) with a Common Code. The International Securities Identification Number (ISIN) for the Notes is XS0773947618 and the Common Code is 077394761.

   The address of Euroclear is 1 Boulevard du Roi Albert II, B-1210 Brussels, Belgium and the address of Clearstream, Luxembourg is 42 Avenue JF Kennedy L-1855 Luxembourg.

8. Where information in this Prospectus has been sourced from third parties this information has been accurately reproduced and as far as the Issuer and Guarantor are aware and are able to ascertain from the information published by such third parties no facts have been omitted which would render the reproduced information inaccurate or misleading. The source of third party information is identified where used.

9. For the period of 12 months starting on the date on which this Prospectus is made available to the public, copies of the following documents will be available, during usual business hours on any weekday (Saturdays, Sundays and public holidays excepted), for inspection at the registered office of the Issuer:

   (a) the Agency Agreement;

   (b) the Trust Deed;

   (c) the articles of association of the Issuer and the Guarantor; and

   (d) a copy of this Prospectus together with any supplemental Prospectus or further prospectus.

   In addition, the Prospectus will be published on the website of the Regulatory News Service operated by the London Stock Exchange at *www.londonstockexchange.com/rns*.

10. The auditors of the Issuer and the Guarantor are Deloitte LLP, Chartered Accountants, who have provided an Accountant's Report on the Historical Financial Information for the Issuer for the three years ended on 31 December 2011. Deloitte LLP have no material interest in the Issuer or the Guarantor.

11. The Trust Deed provides that the Trustee may rely on any certificate or report from an expert or any other person in accordance with the provisions of the Trust Deed whether or not any such certificate or report or any engagement letter or other document entered into by the Trustee in connection therewith contains any limit on the liability of such expert or such other person.

DEFINITIONS

The following definitions apply throughout this Prospectus (other than the financial statements contained at the end of this Prospectus) unless the context otherwise admits, save that capitalised terms used in the section of this Prospectus headed "*Conditions of the Notes*" have the meanings given therein.

"**Accountholder**"	means a person (other than another clearing system) who is for the time being shown in the records of Euroclear or Clearstream, Luxembourg (as the case may be) as the holder of a particular aggregate principal amount of the Notes.
"**Agency Agreement**"	means the agency agreement dated on or around 27 April 2012 relating to the Notes.
"**AM Best**"	means A.M. Best Company, Inc. rating service.
"**Approved Person**"	means a person approved by the FSA to carry out controlled functions under the FSMA.
"**Arrears of Interest**"	has the meaning given in Condition 6.6.
"**Assets**"	has the meaning given in Condition 21.
"**Authorities**"	means, collectively, HM Treasury, the Bank of England and the Financial Services Authority.
"**BaFin**"	means *Bundesanstalt für Finanzdienstleistungs-aufsicht*, the German authority exercising regulation and supervision over the Group's German insurance businesses.
"**Banking Act**"	means the UK Banking Act 2009.
"**BIS**"	an in-house intermediary of the Group that brokers all the RBS/NatWest business.
"**Board**"	means the board of directors of the Company.
"**BTS**"	means Business Technology Services.
"**CAGR**"	means compounded annual growth rate.
"**Capital Disqualification Event**"	has the meaning given in Condition 21.
"**Churchill**"	means Churchill Insurance Company Limited or the Churchill brand, as the case may be.
"**Clearstream, Luxembourg**"	means Clearstream Banking, *société anonyme.*
"**Commercial**"	means the commercial insurance segment of the business of the Group.
"**Condition**"	means, in respect of a numbered Condition, the relevant condition of the Notes set out under "*Conditions of the Notes*".
"**controlled functions**"	means certain key functions in the operation of an insurance business which may only be carried out by Approved Persons as per the FSMA.
"**Company**"	means Direct Line Insurance Group plc.
"**CRR**"	means the capital resources requirement applicable to an insurance company under applicable prudential rules.
"**Disclosure and Transparency Rules**"	means the Disclosure and Transparency Rules as published under the FSA Handbook.

"**divestment**"	means the divestment by RBS Group of the Group pursuant to its 2009 commitment to the European Commission to sell its insurance business as a condition for the receipt of State Aid—see "*The Issuer and the Group—Description of the Business of the Issuer and the Group—History of the Business—Separation from the RBS Group*".
"**DL4B**"	means the "Direct Line for Business" brand of the Issuer.
"**Draft Financial Services Bill**"	means the draft bill published by HM Treasury in June 2011 relating to reforms to the framework for financial regulation in the United Kingdom.
"**ECJ**"	means the European Court of Justice.
"**ECR**"	means the enhanced capital requirement applicable to an insurance company under applicable prudential rules.
"**EIOPA**"	means the European Insurance and Occupational Pensions Authority.
"**Euroclear**"	means Euroclear Bank S.A./N.V.
"**FCA**"	means the Financial Conduct Authority.
"**First Call Date**"	has the meaning given in Condition 21.
"**FSA**" or "**Financial Services Authority**"	means the Financial Services Authority (or any successor authority).
"**FSA Handbook**"	means the book of rules and guidance, including as to regulatory capital requirements, maintained by the FSA.
"**FSMA**"	means the Financial Services and Markets Act 2000 (as amended or re-enacted from time to time).
"**GDP**"	means gross domestic product.
"**GDV**"	means the German Insurance Association.
"**GENPRU**"	means the General Prudential Sourcebook under the FSA Handbook.
"**Global Certificate**"	means the global certificate by which the Notes will, upon issue, be represented.
"**Green Flag**"	means Green Flag Holdings Limited or the Green Flag brand, as the case may be.
"**Group**"	means the Company and its consolidated subsidiaries.
"**Guarantee**"	means the guarantee given by the Guarantor in respect of the Notes, as contained in the Trust Deed.
"**Guaranteed Amounts**"	has the meaning given in Condition 4.1.
"**Guarantor**"	means U K Insurance Limited.
"**Guarantor Mandatory Interest Deferral Date**"	has the meaning given in Condition 21.
"**Guarantor Optional Interest Payment Date**"	has the meaning given in Condition 21.
"**Guarantor Regulatory Deficiency Interest Deferral Event**"	has the meaning given in Condition 21.

"**Guarantor Regulatory Deficiency Redemption Deferral Event**"	has the meaning given in Condition 21.
"**Guarantor Solvency Condition**"	has the meaning given in Condition 4.6.
"**Guarantor Winding-Up**"	has the meaning given in Condition 4.3.
"**GWP**"	means gross written premiums.
"**Historical Financial Information**"	means the historical financial information prepared, on the basis described therein, in respect of the Issuer and its subsidiaries in respect of the three financial years ended 31 December 2011, 2010 and 2009 as contained in this Prospectus on pages F-5 to F-88.
"**HMRC**"	means HM Revenue and Customs.
"**Home**"	means the home insurance segment of the business of the Group.
"**ICA**"	means the Individual Capital Assessment which insurers are required to carry out under applicable prudential rules.
"**ICG**"	means Individual Capital Guidance provided to insurers on a confidential basis and providing a benchmark for the FSA to assess the appropriateness of an insurance company's ICA.
"**ICOBS**"	means the Insurance Conduct of Business Sourcebook under the FSA Handbook.
"**IFRS**"	means International Financial Reporting Standards.
"**IGD**"	means the Directive on the Supplementary Supervision of Insurance Companies in an Insurance Group (Directive 1998/78/EC).
"**IMD**"	means the Insurance Mediation Directive (Directive 2002/92/EC).
"**INSPRU**"	means the Prudential Sourcebook for Insurers under the FSA Handbook.
"**Insurance Groups Directive**"	means the Directive on the Supplementary Supervision of Insurance Companies in an Insurance Group (1998/78/EC).
"**Interest Payment Date**"	has the meaning given in Condition 21.
"**International**"	means the German and Italian motor insurance segment of the business of the Group.
"**IPRU(INS)**"	means the Interim Prudential Sourcebook for Insurers under the FSA Handbook.
"**Issue Date**"	has the meaning given in Condition 21.
"**Issuer**"	means Direct Line Insurance Group plc.
"**Issuer Solvency Condition**"	has the meaning given in Condition 3.4.
"**Issuer Winding-Up**"	has the meaning given in Condition 3.2.
"**ISVAP**"	means the *Instituto per la Vigilanza sulle Assicurazioni Private di Interesse Collettivo*, the Italian authority exercising regulation and supervision over the Group's Italian insurance businesses.

"**IT**"	means information technology.
"**Junior Creditors of the Guarantor**"	has the meaning given in Condition 21.
"**Junior Creditors of the Issuer**"	has the meaning given in Condition 21.
"**Liabilities**"	has the meaning given in Condition 21.
"**Listing Rules**"	means the Listing Rules under the FSA Handbook.
"**London Stock Exchange**"	means the London Stock Exchange plc.
"**Managers**"	means Citigroup Global Markets Limited, HSBC Bank plc and The Royal Bank of Scotland plc.
"**Mandatory Interest Deferral Date**"	has the meaning given in Condition 21.
"**Market**"	means the London Stock Exchange's Regulated Market.
"**Maturity Date**"	has the meaning given in Condition 21.
"**MCR**"	means the minimum capital requirement applicable to an insurance company under applicable prudential rules.
"**Member State**"	means a member state of European Economic Area.
"**Moody's**"	means Moody's Investors Service Limited or, where the context requires, another ratings provider within the Moody's group.
"**Motor**"	means the motor insurance segment of the business of the Group.
"**NIG**"	means The National Insurance and Guarantee Corporation Limited or the NIG brand, as the case may be.
"**Noteholders**"	has the meaning given in Condition 1.2.
"**Notes**"	means the £500,000,000 Fixed/Floating Rate Guaranteed Subordinated Notes due 2042 of the Issuer.
"**Official List**"	means the Official List of the UK Listing Authority.
"**OFT**"	means the Office of Fair Trading.
"**Ogden discount rate**"	means the discount rate used to calculate lump sum awards in bodily injury cases.
"**Optional Interest Payment Date**"	has the meaning given in Condition 21.
"**Pari Passu Creditors of the Guarantor**"	has the meaning given in Condition 21.
"**Pari Passu Creditors of the Issuer**"	has the meaning given in Condition 21.
"**Part IV Permission**"	means a permission from the FSA under Part IV of the FSMA to carry out a regulated business.
"**PCWs**"	means price comparison websites.
"**PPI**"	means payment protection insurance.
"**PPOs**"	means periodic payment orders.

	The Courts Act 2003, implemented in 2005, introduced the ability to award periodic payments orders instead of lump sums in large bodily injury cases. Periodic payment orders replace a lump sum with an index linked amount payable to a claimant annually either for a period of time or for the rest of his/her life.
"**PRA**"	means the Prudential Regulation Authority.
"**Privilege**"	means Privilege Insurance Company Limited or the Privilege brand, as the case may be.
"**Prospectus**"	means this Prospectus dated 25 April 2012.
"**Prospectus Directive**"	means Directive 2003/71/EC.
"**Prospectus Rules**"	means the Prospectus Rules under the FSA Handbook.
"**Qualifying Dated Tier 2 Securities**"	has the meaning given in Condition 21.
"**Rating Agency Compliant Securities**"	has the meaning given in Condition 21.
"**Ratings Methodology Event**"	has the meaning given in Condition 21.
"**RBS**"	means The Royal Bank of Scotland Group plc.
"**RBS Group**"	means The Royal Bank of Scotland Group plc and its subsidiaries.
"**RBS/NatWest**"	means RBS, operating as a partner with the Group through its RBS and NatWest brands
"**Register**"	means the register, maintained by the Registrar, of the registered holders of the Notes.
"**Registrar**"	means The Bank of New York Mellon (Luxembourg) S.A., as registrar in respect of the Notes.
"**Regulation S**"	means Regulation S under the Securities Act.
"**Regulatory Capital Requirements**"	has the meaning given in Condition 21.
"**Regulatory Clearance Condition**"	has the meaning given in Condition 21.
"**Regulatory Deficiency Interest Deferral Event**"	has the meaning given in Condition 21.
"**Regulatory Deficiency Redemption Deferral Event**"	has the meaning given in Condition 21.
"**relevant entity**"	means a regulated UK bank, building society or other institution with permission to accept deposits pursuant to Part IV of the FSMA.
"**Relevant Nominee**"	means the nominee for the clearing systems, which shall be registered in the Register as holder of the Global Certificate on the Issue Date.
"**Relevant Rules**"	has the meaning given in Condition 21.
"**Rescue and other Personal Lines**"	means the rescue and other personal lines insurance segment of the business of the Group.
"**Securities Act**"	means the United States Securities Act of 1933, as amended.
"**Senior Creditors of the Guarantor**"	has the meaning given in Condition 21.
"**Senior Creditors of the Issuer**"	has the meaning given in Condition 21.

"**SMEs**"	means small and medium enterprises.
"**Solvency II**"	means Directive 2009/138/EC of the European Union (as amended) on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) and implementation measures in respect thereof, establishing a new regime in relation to solvency requirements and other matters affecting the financial strength of insurers and reinsurers in the EU.
"**SRR**"	means the special resolution regime under the Banking Act.
"**Standard & Poor's**"	means Standard & Poor's Credit Market Services Europe Limited or, where the context requires, another ratings provider within the Standard & Poor's group.
"**State Aid**"	means the aid given to the RBS Group by HM Treasury in December 2008.
"**State Aid restructuring plan**"	means the restructuring plan that was approved by the RBS Group, together with HM Treasury, as part of the terms of the State Aid approval.
"**Substitute Obligor**"	has the meaning given in Condition 14.
"**technical reserves**"	means "insurance liabilities" as used within the Historical Financial Information.
"**Threshold Conditions**"	means the FSMA Threshold Conditions for granting a Part IV Permission.
"**TPF**"	means Tesco Personal Finance Limited.
"**Trust Deed**"	means the trust deed dated 27 April 2012 between the Issuer, the Guarantor and the Trustee constituting the Notes.
"**Trustee**"	means BNY Mellon Corporate Trustee Services Limited.
"**TSA**"	means the Transitional Services Agreement the Group expects to enter into with the RBS Group prior to divestment from the RBS Group, pursuant to which the RBS Group will continue to provide certain information technology and other support to the Group following the divestment.
"**U K Insurance**"	means U K Insurance Limited.

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Historical Financial Information F-5

BASIS OF PREPARATION OF THE HISTORICAL FINANCIAL INFORMATION

The combined financial information for the three years ended 31 December 2011, 2010 and 2009 has been prepared for the combined group which comprises the Company and its subsidiaries, and Direct Line Versicherung AG (together referred to as the "**Group**" for the purposes of this section "*Basis of Preparation of the Historical Financial Information*"). The combined financial information has been prepared on a historical cost basis except for investment properties and those financial instruments that have been measured at fair value.

The combined financial information has been prepared in accordance with the requirements of the Prospectus Directive Regulation and the Listing Rules and in accordance with this basis of preparation. The basis of preparation describes how the financial information has been prepared in accordance with International Financial Reporting Standards ("**IFRS**") as adopted by the European Union ("**EU**") except as described below.

IFRS as adopted by the EU do not provide for the preparation of combined financial information and accordingly, in preparing the combined financial information certain accounting conventions commonly used in the preparation of historical financial information for the inclusion in investment circulars as described in the Annexure to SIR 2000 (Investment Reporting Standard applicable to public reporting engagements on historical financial information) issued by the UK Auditing Practices Board have been applied. The application of these conventions results in the following material departures from IFRS as adopted by the EU. In all other respects, IFRS as adopted by the EU has been applied:

- the Group was formed on 2 April 2012 when the Company acquired Direct Line Versicherung AG. Prior to this date, the Group was not held by a single legal entity and, accordingly, consolidated financial statements do not exist. The combined financial information has been prepared using merger accounting principles, as if the transaction that gave rise to the formation of the Group had taken place at the beginning of the comparative period. Under these principles, the combined financial information has been prepared as if the Company were the holding company of Direct Line Versicherung AG from 1 January 2009, the date of the beginning of the comparative period. The assets, liabilities and the profit or loss of the Company and its subsidiaries and Direct Line Versicherung AG have been combined and all transactions and balances between the entities included within the Group consolidation have been eliminated. The combined financial information reflects a liability for the Direct Line Versicherung AG consideration. As the basis of preparation represents a reorganisation of entities under common control, it is therefore outside the scope of IFRS 3, Business Combinations. Accordingly, as permitted by IAS 8, it has been accounted for as a group reorganisation as described in UK accounting literature; and
- the preparation of the combined financial information has required the allocation of certain RBS Group costs to the Group. While such costs have been allocated on the basis intended to reflect their nature, the financial information has not necessarily reflected the results of the Group had it been a stand-alone group during this time. As these cost allocations did not result in a corresponding cash payment, they are offset by an entry in equity, described as 'demerger reserves', and are reflected in the notes to the cash flow statements (Note 36) within 'non cash movement in demerger reserves'.

DELOITTE LLP ACCOUNTANT'S REPORT

Deloitte.

Athene Place
66 Shoe Lane
London
EC4A 3BQ

The Board of Directors
on behalf of Direct Line Insurance Group plc
Churchill Court
Westmoreland Road
Bromley
Kent
BR1 1DP

25 April 2012

Dear Sirs

Direct Line Insurance Group plc

We report on the financial information for the three years ended 31 December 2011, 2010 and 2009 set out on pages F-5 to F-88 of the debt prospectus dated 25 April 2012 of Direct Line Insurance Group plc (the "Company" and, together with its subsidiaries, the "Group") (the "Prospectus"). This financial information has been prepared for inclusion in the Prospectus on the basis of the accounting policies set out in Note 1 to the financial information. This report is required by Annex IX item 11.1 of Commission Regulation (EC) No 809/2004 (the "Prospectus Directive Regulation") and is given for the purpose of complying with that requirement and for no other purpose.

Responsibilities

The Directors of the Company are responsible for preparing the financial information on the basis of preparation set out in Note 1 to the financial information.

It is our responsibility to form an opinion on the financial information and to report our opinion to you.

Save for any responsibility arising under Prospectus Rule 5.5.4R(2)(f) to any person as and to the extent there provided, to the fullest extent permitted by law we do not assume any responsibility and will not accept any liability to any other person for any loss suffered by any such other person as a result of, arising out of, or in accordance with this report or our statement, required by and given solely for the purposes of complying with Annex IX item 13.1 of the Prospectus Directive Regulation, consenting to its inclusion in the Prospectus.

Basis of opinion

We conducted our work in accordance with Standards for Investment Reporting issued by the Auditing Practices Board in the United Kingdom. Our work included an assessment of evidence relevant to the amounts and disclosures in the financial information. It also included an assessment of significant estimates and judgments made by those responsible for the preparation of the financial information and whether the accounting policies are appropriate to the entity's circumstances, consistently applied and adequately disclosed.

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial information is free from material misstatement whether caused by fraud or other irregularity or error.

Our work has not been carried out in accordance with auditing or other standards and practices generally accepted in jurisdictions outside the United Kingdom, including the United States of America, and accordingly should not be relied upon as if it had been carried out in accordance with those standards and practices.

Opinion on financial information

In our opinion, the financial information gives, for the purposes of the Prospectus, a true and fair view of the state of affairs of the Group as at 31 December 2011, 2010 and 2009 and of its profits, cash flows and changes in equity for the three years ended 31 December 2011, 2010 and 2009 in accordance with the basis of preparation set out in Note 1 to the financial information.

Declaration

For the purposes of Prospectus Rule 5.5.4R(2)(f), we are responsible for this report as part of the Prospectus and declare that we have taken all reasonable care to ensure that the information contained in this report is, to the best of our knowledge, in accordance with the facts and contains no omission likely to affect its import. This declaration is included in the Prospectus in compliance with Annex IX item 1.2 of the Prospectus Directive Regulation.

Yours faithfully

Deloitte LLP

Deloitte LLP
Chartered Accountants

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Deloitte LLP is the United Kingdom member firm of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, whose member firms are legally separate and independent entities. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Member of Deloitte Touche Tohmatsu Limited

DIRECT LINE INSURANCE GROUP PLC

HISTORICAL FINANCIAL INFORMATION

FOR THE YEARS ENDED 31 DECEMBER 2011, 31 DECEMBER 2010 AND 31 DECEMBER 2009

DIRECT LINE INSURANCE GROUP PLC

COMBINED INCOME STATEMENT

FOR THE YEARS ENDED 31 DECEMBER 2011, 2010 AND 2009

	Notes	2011 £ Million	2010 £ Million	2009 £ Million
Gross earned premium	5	4,522.9	5,152.4	5,330.4
Reinsurance premium ceded	5	(269.9)	(178.9)	(202.1)
Net earned premium		**4,253.0**	**4,973.5**	**5,128.3**
Investment return	6	281.9	321.7	365.6
Instalment income	7	145.0	187.7	155.9
Other operating income	7	95.1	107.5	78.6
Total income		**4,775.0**	**5,590.4**	**5,728.4**
Insurance claims	8	(3,160.6)	(4,884.7)	(4,301.7)
Insurance claims recoverable from reinsurers	8	193.1	256.7	119.4
Net insurance claims		**(2,967.5)**	**(4,628.0)**	**(4,182.3)**
Commission expenses	9	(518.9)	(378.7)	(560.8)
Other operating expenses	10	(944.6)	(959.1)	(1,064.8)
Total expenses		**(1,463.5)**	**(1,337.8)**	**(1,625.6)**
Operating profit/(loss)		**344.0**	**(375.4)**	**(79.5)**
Finance costs	11	(2.7)	(2.7)	(4.4)
Gain recognised on disposal of subsidiary and joint venture	21	1.6	—	216.1
Profit/(loss) before tax		**342.9**	**(378.1)**	**132.2**
Tax (charge)/credit	12	(93.9)	106.2	0.9
Profit/(loss) for the year	15	**249.0**	**(271.9)**	**133.1**
Profit/(loss) attributable to:				
Owners of the Company		249.0	(271.9)	133.1
Non-controlling interests		—	—	—
		249.0	**(271.9)**	**133.1**
Earnings/(loss) per share				
— basic & diluted (pence)	14	16.6	(18.1)	8.9

DIRECT LINE INSURANCE GROUP PLC

COMBINED STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEARS ENDED 31 DECEMBER 2011, 2010 AND 2009

	Notes	2011 £ Million	2010 £ Million	2009 £ Million
Profit/(loss) for the year		**249.0**	**(271.9)**	**133.1**
Other comprehensive income/(loss)				
Actuarial (loss)/gain on defined benefit plan	33	(0.6)	10.9	(8.6)
Exchange differences on translation of foreign operations		(3.5)	(2.8)	(19.6)
Fair value gain on available-for-sale investments	28	183.8	133.6	247.9
Less: reclassification adjustments for gains	28	(52.3)	(46.8)	(62.1)
		127.4	94.9	157.6
Tax on other comprehensive income		(36.8)	(27.4)	(41.5)
Other comprehensive income for the year		**90.6**	**67.5**	**116.1**
Total comprehensive income/(loss) for the year		**339.6**	**(204.4)**	**249.2**
Total comprehensive income attributable to:				
Owners of the Company		339.6	(204.4)	249.2
Non-controlling interests		—	—	—
		339.6	**(204.4)**	**249.2**

DIRECT LINE INSURANCE GROUP PLC

COMBINED BALANCE SHEET

AS AT 31 DECEMBER 2011, 2010 AND 2009

	Notes	2011 £ Million	2010 £ Million	2009 £ Million
ASSETS				
Goodwill and other intangible assets	20	365.8	286.1	290.3
Property, plant and equipment	18	46.9	52.6	59.2
Investment property	19	69.5	83.5	77.8
Reinsurance assets	22	741.6	660.9	517.6
Deferred acquisition costs	23	310.5	299.5	338.5
Prepayments, accrued income and other assets		92.2	113.3	92.2
Insurance and other receivables	25	1,252.9	1,606.2	1,732.8
Current tax assets	12	—	25.9	50.8
Deferred tax assets	13	26.9	17.0	17.1
Derivative financial instruments	32	0.1	—	1.3
Retirement benefit asset	33	2.6	—	—
Financial investments	24	9,480.3	8,830.5	8,747.9
Cash and cash equivalents	26	1,379.8	1,841.4	1,260.3
Assets held for sale	17	1.0	—	—
Total assets		**13,770.1**	**13,816.9**	**13,185.8**
EQUITY				
Invested capital	27	1,500.0	1,500.0	1,500.0
Other reserves	28	575.2	590.4	411.4
Retained earnings	28	1,537.6	1,133.2	1,410.7
Total invested equity		3,612.8	3,223.6	3,322.1
Non-controlling interest	28	258.5	258.5	258.5
Total equity		**3,871.3**	**3,482.1**	**3,580.6**
LIABILITIES				
Insurance liabilities	29, 30	6,509.0	6,941.4	5,928.5
Unearned premium reserve	29	1,931.6	2,288.6	2,499.8
Borrowings	31	317.9	327.1	285.2
Derivative financial instruments	32	—	0.7	—
Retirement benefit obligations	33	—	0.1	13.6
Trade and other payables including insurance payables	34	910.2	698.0	801.0
Deferred tax liabilities	13	12.1	76.3	76.8
Current tax liabilities	12	218.0	2.6	0.3
Total liabilities		**9,898.8**	**10,334.8**	**9,605.2**
Total equity and liabilities		**13,770.1**	**13,816.9**	**13,185.8**

DIRECT LINE INSURANCE GROUP PLC

COMBINED STATEMENT OF CHANGES IN EQUITY

FOR THE YEARS ENDED 31 DECEMBER 2011, 2010 AND 2009

	Note	Invested capital £ Million	Other reserves £ Million	Retained earnings £ Million	Total invested equity £ Million	Non-controlling interest £ Million	Total equity £ Million
Balance as at 1 January 2009		1,500.0	119.0	1,312.6	2,931.6	258.5	3,190.1
Profit for the year		—	—	133.1	133.1	—	133.1
Other comprehensive income		—	122.4	(6.3)	116.1	—	116.1
Transfers to/(from) non distributable reserves	28	—	25.3	(25.3)	—	—	—
Movement in demerger reserve	28	—	143.3	—	143.3	—	143.3
Movement in net assets of Direct Line Versicherung AG		—	1.4	(3.4)	(2.0)	—	(2.0)
Balance as at 31 December 2009		1,500.0	411.4	1,410.7	3,322.1	258.5	3,580.6
Loss for the year		—	—	(271.9)	(271.9)	—	(271.9)
Other comprehensive income		—	59.5	8.0	67.5	—	67.5
Transfers to/(from) non distributable reserves	28	—	14.0	(14.0)	—	—	—
Movement in demerger reserve	28	—	102.2	—	102.2	—	102.2
Movement in net assets of Direct Line Versicherung AG		—	3.3	0.4	3.7	—	3.7
Balance as at 31 December 2010		1,500.0	590.4	1,133.2	3,223.6	258.5	3,482.1
Profit for the year		—	—	249.0	249.0	—	249.0
Other comprehensive income		—	91.2	(0.6)	90.6	—	90.6
Transfers to/(from) non distributable reserves	28	—	(167.3)	167.3	—	—	—
Movement in demerger reserve	28	—	55.9	—	55.9	—	55.9
Movement in net assets of Direct Line Versicherung AG		—	5.0	(11.3)	(6.3)	—	(6.3)
Balance as at 31 December 2011		1,500.0	575.2	1,537.6	3,612.8	258.5	3,871.3

DIRECT LINE INSURANCE GROUP PLC

COMBINED CASH FLOW STATEMENT

AS AT 31 DECEMBER 2011, 2010 AND 2009

	Notes	2011 £ Million	2010 £ Million	2009 £ Million
Net cash (used by)/generated from operating activities before investment of insurance assets	36	**(245.8)**	**459.8**	**(370.5)**
Cash generated from investment of insurance assets	36	38.8	486.0	875.7
Net cash (used by)/generated from operating activities		**(207.0)**	**945.8**	**505.2**
Cash flows from investing activities				
Proceeds on disposal of property, plant and equipment		1.2	0.1	1.6
Purchases of property, plant and equipment		(7.5)	(5.2)	(8.4)
Purchases of intangible assets		(119.8)	(26.2)	(8.1)
Net cash flows from disposal of subsidiary and joint venture	21	(0.1)	—	330.9
Net cash (used by)/generated from investing activities		**(126.2)**	**(31.3)**	**316.0**
Cash flows from financing activities				
Repayments of borrowings		(205.0)	(242.2)	—
Net loan advances to related parties		(114.5)	(129.3)	(34.9)
Proceeds from borrowings		205.0	—	226.5
Net cash (used by)/generated from financing activities		**(114.5)**	**(371.5)**	**191.6**
Net (decrease)/increase in cash and cash equivalents		**(447.7)**	**543.0**	**1,012.8**
Cash and cash equivalents at the beginning of the year	26	1,763.5	1,225.9	238.5
Effect of foreign exchange rate changes		(6.2)	(5.4)	(25.4)
Cash and cash equivalents at the end of the year	26	**1,309.6**	**1,763.5**	**1,225.9**

The Group classifies the cash flows for the purchase and disposal of financial assets in its operating cash flows as the purchases are funded from the cash flows associated with the origination of insurance contracts, net of the cash flows from payment of insurance claims.

DIRECT LINE INSURANCE GROUP PLC
NOTES TO THE FINANCIAL INFORMATION

Corporate information

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

The Company, formerly RBS Insurance Group Limited, was incorporated on 26 July 1988 as a private limited company with a registered number 02280426 as a wholly owned subsidiary of The Royal Bank of Scotland Group plc ("RBS Group"). RBS Group comprises The Royal Bank of Scotland Group plc and its subsidiaries.

In 2009, RBS Group committed to the European Commission to sell its insurance business as a condition of its receipt of State Aid. To comply with this requirement, RBS Group must cede control of the Company by the end of 2013 and must have divested its entire interest by the end of 2014.

1. ACCOUNTING POLICIES

Basis of preparation

The combined financial information for the three years ended 31 December 2011, 2010 and 2009 has been prepared for the combined group which comprises the Company and its subsidiaries, and Direct Line Versicherung AG (together the "Group"). The combined financial information has been prepared on a historical cost basis except for investment properties and those financial instruments that have been measured at fair value.

The combined financial information has been prepared in accordance with the requirements of the PD regulation and the Listing Rules and in accordance with this basis of preparation. The basis of preparation describes how the financial information has been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU") except as described below.

IFRSs as adopted by the EU do not provide for the preparation of combined financial information and accordingly, in preparing the combined financial information certain accounting conventions commonly used in the preparation of historical financial information for the inclusion in investment circulars as described in the Annexure to SIR 2000 (Investment Reporting Standard applicable to public reporting engagements on historical financial information) issued by the UK Auditing Practices Board have been applied. The application of these conventions results in the following material departure from IFRSs as adopted by the EU. In all other respects, IFRSs as adopted by the EU has been applied.

- the Group was formed on 2 April 2012 when the Company acquired Direct Line Versicherung AG. Prior to this date, the Group was not held by a single legal entity and, accordingly, consolidated financial statements do not exist. The combined financial information has been prepared using merger accounting principles, as if the transaction that gave rise to the formation of the Group had taken place at the beginning of the comparative period. Under these principles, the combined financial information has been prepared as if the Company were the holding company of Direct Line Versicherung AG from 1 January 2009, the date of the beginning of the comparative period. The assets, liabilities and the profit or loss of the Company and its subsidiaries and Direct Line Versicherung AG have been combined and all transactions and balances between the entities included within the Group consolidation have been eliminated. The combined financial information reflects a liability for the Direct Line Versicherung AG consideration. As the basis of preparation represents a reorganisation of entities under common control, it is therefore outside the scope of IFRS 3, Business Combinations. Accordingly, as permitted by IAS 8, it has been accounted for as a group reorganisation as described in UK accounting literature; and
- the preparation of the combined financial information has required the allocation of certain RBS Group costs to the Group. While such costs have been allocated on the basis intended to reflect their nature, the financial information has not necessarily reflected the results of the Group had it been a stand-alone group during this time. As these cost allocations did not result in a corresponding cash payment, they are offset by an entry in equity, described as 'demerger reserves',

1. ACCOUNTING POLICIES (Continued)

and are reflected in the notes to the cash flow statements (Note 36) within 'non cash movement in demerger reserves'.

Adoption of new and revised standards

The IASB issued a revised IAS24 Related Party Disclosure in November 2009 clarifying the existing standard and to provide exemptions for entities under government control. The revised standard became effective for accounting periods beginning on or after 1 January 2011. The Group has chosen to adopt the exemption of disclosure of other government controlled entities outside of the RBS Group as related parties.

1.1 Basis of consolidation and combination

The financial information comprises the financial statements of each of the companies within the Direct Line Insurance Group as at 31 December each year.

The results of subsidiaries acquired or disposed of during the period are included in the combined income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate. 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. All intra-group transactions, balances, income and expenses are eliminated on combination. The policies set out below have been applied consistently throughout all the periods presented to items considered material to the combined financial information.

As set out in the basis of preparation note above, Direct Line Versicherung AG was not owned or controlled by Direct Line Insurance Group plc as at 31 December 2011 either directly or indirectly. Therefore the assets and liabilities of this company have been combined with those of the consolidated Group companies to present financial information for the Group as it is constituted from 2 April 2012.

1.2 Foreign currencies

The Group's combined financial information are presented in sterling which is the functional currency of the Group. Group entities record transactions in the currency of the primary economic environment in which they operate (their functional currency) 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 arising on hedges of net investments in foreign operations. 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 profit or loss except for differences arising on available-for-sale non-monetary-financial assets, for example equity shares 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 sterling at the foreign exchange rates ruling at the balance sheet date. Income and expenses of foreign operations are translated into 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 combined statement of other comprehensive income. The amount accumulated in equity is reclassified from equity to the combined income statement on disposal or partial disposal of a foreign operation.

1. ACCOUNTING POLICIES (Continued)

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 policyholders if a specified uncertain future event (the insured event) adversely affects the policyholders.

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 or expire.

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 that relate to periods of insurance 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. Insurance premiums exclude insurance premium tax or equivalent local taxes.

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 Group's long-term assurance contracts include whole-life and term assurance contracts that are expected to remain in force for an extended period of time. These contracts insure events associated with human life (for example death or the occurrence of a critical illness). These are recognised as revenue when they become payable by the contract holder. Premiums are shown before the deduction of commission.

Investment return

Interest income on financial assets that are classified as available-for-sale other than those at fair value through income statement are determined using the effective interest rate method. The effective interest rate method is a method 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 available-for-sale assets estimates are based on the straight-line method, which management has determined is a close approximation to the effective interest rate.

Rental income from investment properties 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 balances, 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

Referral fees

Invoices relating to this activity are issued on a monthly basis for revenue receivable from third parties, and the revenue is recognised in full on the date of the invoice. With respect to the fixed term contracts, monthly invoices are issued to the third parties in arrears. The revenue for the current month is

1. ACCOUNTING POLICIES (Continued)

accrued for and recognised immediately. The arrangements are contractual and the cost of providing the service is recognised as the service is rendered.

Vehicle recovery, repairs and management systems income

Fees in respect of services for vehicle recovery are recognised as the right to consideration accrues 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 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 and sales taxes have been deducted where applicable.

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

Other income

Commission fee income in respect of services is recognised when a policy has been placed and incepted.

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 periodical payment orders ("PPOs") established under the Courts Act 2003, implemented in 2005. 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 notes 2.1 and 3.5.1. 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. In order to calculate 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.

For more recent claim periods the provisions will make use of techniques that incorporate expected loss ratios and inflated average claims cost and frequency methods. As periods mature, the reserves 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 internally generated and reconciled to the accounting data as part of the process.

The insurance claims reserves are 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.

1. ACCOUNTING POLICIES (Continued)

Actual claims experience may differ from the historical pattern on which the estimate is based and the cost of settling individual claims may exceed that assumed. As a result management adopt a cautious view and use the work of internal and external actuaries to assess the level of gross and net outstanding claims provision required and adopt a measurement basis of reserves which results in a provision in excess of the actuarial best estimate. It is this amount that is recorded as claims reserves.

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 (eg. 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 line of business. 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 periodical payment orders are discounted for the time value of money.

A reinsurance bad debt provision is assessed in respect of outstanding reinsurance claims, 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 outstanding reinsurance claims to reflect the credit risk exposure to long-term reinsurance assets particularly in relation to periodical payments. This is effected 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 so deferred are direct advertising expenditure, third party administration fees, commission paid and costs associated with the 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 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.

1. ACCOUNTING POLICIES (Continued)

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 other operating expenses. The estimated useful economic lives are as follows:

Computer software	3 to 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 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 are expected to generate economic benefits beyond one year are also capitalised.

1.9 Property, plant and equipment

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

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

Freehold and long leasehold buildings	50 years or the period of the lease if shorter
Vehicles	5 years
Computer equipment	Up to 5 years
Other equipment, including property adaptation costs	4 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 from those of other assets or groups of assets, the recoverable amount is determined for the cash-generating unit 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 cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash-generating unit 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 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 that which it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

1. ACCOUNTING POLICIES (Continued)

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 and is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in the income statement.

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

1.12 Financial assets

On initial recognition financial assets are classified as held to maturity; available-for-sale; held for trading; designated as at fair value through profit or loss; or loans and receivables. The Group only has available-for-sale financial assets and loans and receivables.

Available-for-sale—Financial assets that are not classified as held-to-maturity; held for trading; designated as at fair value through profit or loss; or loans and receivables, are classified as available-for-sale. Financial assets can be designated as available-for-sale on initial recognition. Available-for-sale 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 available-for-sale financial assets are recognised in profit or loss together with interest calculated using the effective interest rate method. Other changes in the fair value of available-for-sale 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 (e.g. 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 fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the Group uses that technique.

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

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

1. ACCOUNTING POLICIES (Continued)

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

Loans and receivables—Non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables, except those that are classified as available-for-sale or designated as at fair value through the income statement. Loans and receivables are initially recognised at fair value plus directly related transaction costs. They 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.

Other loans and receivables principally comprise loans to related parties and other debtors.

Impairment of financial assets

The Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets classified as available-for-sale 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.

Available-for-sale—When a decline in the fair value of a financial asset classified as available-for-sale 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 available-for-sale equity instruments are not reversed through profit or loss, but those on available-for-sale 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 available-for-sale other investment funds are all 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 written off to the income statement and the bad debt provision is written 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

1. ACCOUNTING POLICIES (Continued)

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 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 currently enters into one type of hedge relationship: hedges of the net investment in a foreign operation.

Hedge relationships are formally documented at inception. The documentation identifies the hedged item, 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 attributable to the hedged risk, consistent with the documented risk management strategy, 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 is recognised directly in equity. Any ineffective portion is recognised in the income statement. Non-derivative financial liabilities as well as derivatives may be the hedging instrument in a net investment hedge.

1.13 Cash and cash equivalents

Cash and cash equivalents comprises cash on 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 and group loans are measured at amortised cost using the effective interest method.

1.14 Financial liabilities

Amortised cost

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 method.

1.15 Provisions

Regulatory levies

The Group accrues for all insurance industry levies, such as the Financial Services Compensation Scheme and Motor Insurance Bureau in the UK, as a provision in the balance sheet and not within insurance liabilities. The levy accruals are based on past underwriting levels at the best estimate rate given the available information at the balance sheet date. They are charged to the income statement as an expense.

1.16 Leases

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

1.17 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.

1. ACCOUNTING POLICIES (Continued)

Contributions to the Group's defined contribution pension scheme are recognised in the income statement when payable. As described in note 33, the Group's defined benefit pension scheme 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 expected return on scheme assets less the unwinding of the discount on the scheme liabilities is charged 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.

Certain employees of the Group have defined benefit pension arrangements with RBS Group entities. There is no contractual agreement or policy on the way that the cost of RBS Group defined benefit pension schemes and healthcare plans are allocated to the Group. It therefore accounts for the charges it incurs as payments to a defined contribution scheme.

1.18 Taxation

Provision is made for taxation at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas taxation where appropriate.

Deferred taxation is accounted for in full for all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes, except in relation to overseas earnings where remittance is controlled by the Group, and goodwill.

Deferred tax assets are only recognised to the extent that it is probable that they will be recovered.

1.19 Share-based payments

RBS Group issues equity-settled share-based payments to certain employees of the Group. Equity-settled share-based payments are measured at fair value (excluding the effect of non market-based vesting conditions) at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, adjusted for the effect of non market-based vesting conditions. The fair value of an option is estimated using valuation techniques which take into account its exercise price, its term, the risk free interest rate and the expected volatility of the market price of The Royal Bank of Scotland Group plc's shares.

Given that the Group's employees directly benefit from participation in these plans, the expense incurred by RBS Group for options granted to the employees has been reflected in the Group's combined financial income statement as other operating expenses. The compensation expense recognised for share options plans was immaterial for 2011, 2010 and 2009.

1.20 Capital

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.

1.21 Accounting developments

The IASB issued an amendment to IAS 12 'Income Taxes' in December 2010 to clarify that recognition of deferred tax should have regard to the expected manner of recovery or settlement of the asset or liability. The amendment and consequential withdrawal of SIC 21 'Deferred Tax: Recovery of Underlying Assets', effective for annual periods beginning on or after 1 January 2012, is not expected to have a material effect on the Group.

1. ACCOUNTING POLICIES (Continued)

IFRS 10 Consolidated Financial Statements, which replaces SIC-12 Consolidation—Special Purpose Entities and the consolidation elements of the existing IAS 27 Consolidated and Separate Financial Statements, was issued by the IASB in May 2011. The new standard adopts a single definition of control: a reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity. Effective for annual periods beginning on or after 1 January 2013, the new standard is not expected to have any effect on the Group.

In May 2011 the IASB issued amendments to IAS 27 Separate Financial Statements which comprises those parts of the existing IAS 27 that dealt with separate financial statements, effective for annual periods beginning on or after 1 January 2013. The amendment to this standard is not expected to have any effect on the Group.

IFRS 11 Joint Arrangements, which supersedes IAS 31 Interests in Joint Ventures, was issued by the IASB in May 2011. Joint operations are accounted for by the investor recognising its assets and liabilities including its share of any assets held and liabilities incurred jointly and its share of revenues and costs. Joint ventures are accounted for in the investor's consolidated accounts using the equity method. Effective for annual periods beginning on or after 1 January 2013, the Company does not have any joint arrangements at this time and therefore this standard would not have had any impact on the Group.

In May 2011 the IASB issued amendments to IAS 28 Investments in Associates and Joint Ventures to cover joint ventures as well as associates; both must be accounted for using the equity method. The mechanics of the equity method are unchanged. Effective for annual periods beginning on or after 1 January 2013, the amendments to this standard are not expected to have any effect on the Group.

IFRS 12 Disclosure of Interests in Other Entities covers disclosures for entities reporting under IFRS 10 and IFRS 11 replacing those in IAS 28 and IAS 27 and was issued by the IASB in May 2011. Entities are required to disclose information that helps financial statement readers evaluate the nature, risks and financial effects associated with an entity's interests in subsidiaries, in associates and joint arrangements and in unconsolidated structured entities. The new standard is effective for annual periods beginning on or after 1 January 2013, and is not expected to have any effect on the Group.

In May 2011 the IASB issued IFRS 13 Fair Value Measurement which sets out a single IFRS framework for defining and measuring fair value and requiring disclosures about fair value measurements, effective for annual periods beginning on or after 1 January 2013. The new standard will have an impact on the quantitative and qualitative disclosure requirements of financial assets and liabilities of the Group that are not covered by IFRS 7 Financial Instruments: Disclosures.

Amendments to IAS 1 Presentation of Items of Other Comprehensive Income that require items that will never be recognised in profit or loss to be presented separately in other comprehensive income from those that are subject to subsequent reclassification, was issued by the IASB in June 2011. The amendments are effective for annual periods beginning on or after 1 July 2012, and will have an impact the disclosure requirements of the Group's financial statements.

Amendments to IAS 19 Employee Benefits which require the immediate recognition of all actuarial gains and losses eliminating the 'corridor approach'; interest costs to be calculated on the net pension liability or asset at the appropriate corporate bond rate; and all past service costs to be recognised immediately when a scheme is curtailed or amended, were issued by the IASB in June 2011. The amendments are effective for annual periods beginning on or after 1 January 2013 and it is not expected to have any impact on the Group as the Group does not use the corridor approach.

In December 2011 the IASB issued amendments to IFRS 7 Financial Instruments: Disclosure—Offsetting financial assets and financial liabilities. The amended disclosure requirements are intended to enable the evaluation of the effect or potential effect of netting arrangements as permitted by IAS 32 (paragraph 42), on the financial statements. The amendments are effective for annual periods beginning on or after 1 January 2013 and is not expected to have any effect on the Group.

1. ACCOUNTING POLICIES (Continued)

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

The IASB has published IFRS 9: Financial Instruments: recognition and measurement, that will apply to financial years beginning on 1 January 2015. The new standard has not been adopted by the EU, nor is there a timetable when an approval can be expected. The standard is a complete revision and will replace the current standard IAS 39, Financial Instruments: Recognition and Measurement. The standard reduces the number of valuation categories for financial assets and means that they are recognised at amortised cost or fair value through profit or loss. The rules for financial liabilities correspond to the existing rules in IAS 39 plus a supplement on how credit risk is presented when financial liabilities are measured at fair value. The change in the credit risk for financial liabilities designated at fair value according to the so-called fair value option is normally presented in other comprehensive income and not in the traditional income statement, provided that further inconsistencies do not arise in presentation of any eliminated changes in value.

The standard will be complemented by new rules for impairment of financial assets that are categorised as financial assets at amortised cost and new rules for hedge accounting. The adoption of IFRS 9 which the Group plans not to adopt before the year beginning on 1 January 2015 will impact both the measurement and disclosures of financial instruments.

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 F-11 to F-22. UK company law and IFRS 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 'Accounting Policies, Changes in Accounting Estimates and Errors' 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 loss adjustment expenses. Outstanding claims provisions net of related reinsurance recoveries at 31 December 2011 amounted to £5,807.7 million (2010: £6,311.0 million, 2009: £5,434.1 million).

Outstanding claims provisions are not discounted for the time value of money except for those in respect of PPOs under the Courts Act 2003. Total discounted reserves for claims which have already been settled by way of a PPO are £203.9 million (2010: £204.9 million; 2009: £91.6 million) gross and £80.3 million (2010: £35.5 million, 2009: £26.1 million) net of reinsurance. The corresponding undiscounted amounts are £730.4 million (2010: £707.2 million; 2009: £296.5 million) gross and £245.1 million (2010: £134.3 million; 2009: £41.0 million) net of reinsurance. Total discounted claims reserves estimated to be settled by PPOs in respect of both claims reported prior to the year end and incurred but not reported claims at the year end are £1,166.5 million (2010: £1,180.0 million; 2009: £91.6 million) gross and £835.3 million (2010: £826.6 million; 2009: £26.1 million) net of reinsurance. The corresponding undiscounted amounts are £3,856.9 million (2010: £4,320.9 million; 2009: £275.7 million) gross and £2,404.9 million (2010: £2,659.6 million; 2009: £61.8 million) net of reinsurance.

2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

The amounts for 2011 and 2010 include a provision for estimated PPOs incurred but not reported which is not available for 2009.

The rate of interest used for the calculation of present values is 4.5% (2010: 4.5%, 2009: 4.14%). The average interval between the date of the last future cash flow being discounted and the end of the financial year is 50 years on settled cases (2010: 50 years, 2009: 40 years). This is calculated for each of the claims settled by PPO as the mean of the insurer's and the claimant's expert medical advice on the claimant's life expectancy. The value of claims with a periodical payment are calculated via a cash flow model. The PPO are projected using the terms of the settlement, the assumed life expectancy, and adjusted for the inflation agreed in the settlement. Outstanding lump sums are estimated using the claims handlers' case estimates, for both the claim with the PPO and any other claims arising from the same accident. Reinsurance is calculated on the accident's entire costs, and the net cash flows are discounted for the time value of money to allow for investment earnings. Details on sensitivity analysis are shown in note 3.6.1.

2.2 Impairment provisions—financial assets

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

Every month, the Group reviews whether there is any objective evidence that the direct investments in debt securities are impaired based on the following criteria:

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

Impairment provisions on debt securities available-for-sale financial assets at 31 December 2011 amounted to £2.0 million (2010: £21.4 million, 2009: nil).

Had all the declines in available-for-sale asset values met the criteria above, the Group would suffer a further £37.3 million loss in its 2011 financial information (2010: £58.2 million loss, 2009: £102.3 million loss), being the transfer of the total available-for-sale reserve for unrealised losses to the income statement.

2.3 Fair value

Financial assets classified as available-for-sale are recognised in the financial information at fair value. In the balance sheet, financial assets carried at fair value are included within available-for-sale debt securities and equity shares. Unrealised gains and losses on available-for-sale financial assets are recognised directly in other comprehensive income unless an impairment loss is recognised.

The fair value of all available-for-sale financial assets at 31 December 2011 were determined using observable market input and amounted to £7,990.7 million (2010: £7,867.1 million, 2009: £7,346.6 million). The judgements and assumptions adopted by management in the valuation of available-for-sale financial assets when a market is not active, require the use of valuation techniques. These valuation techniques involve a degree of estimation and are noted in note 1.12. Details on sensitivity analysis are shown in note 3.6.1.

2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)

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 as at 31 December 2011 amounted to £310.5 million (2010: £299.5 million, 2009: £338.5 million). During 2011, management reviewed the costs included in the calculation of deferred acquisition costs and considers them to be appropriate, and have estimated that they are recoverable.

2.5 Goodwill

The Group capitalises goodwill arising on the acquisition of businesses as discussed in accounting policy 1.8. The carrying value of goodwill as at 31 December 2011 was £211.0 million (2010: £221.2 million, 2009: £230.5 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 of the acquisition. 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 cash-generating units or groups of cash-generating units expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a cash-generating unit or group of cash-generating units with its recoverable amount. The recoverable amount is the higher of the unit's fair value and its value in use. Value in use is the present value of expected future cash flows from the cash-generating unit or group of cash-generating units. Fair value is the amount obtainable for the sale of the cash-generating unit in an arm's length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgemental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of cash-generating units; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details on sensitivity analysis are shown in note 20.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK

3.1 Risk Management Overview

Risk management is at the heart of the insurance business. The Group issues contracts that accept insurance risk in return for a premium. The Group is also subject to investment risk (market risk and credit risk), other credit risk, liquidity risk, regulatory risk, operational risk and group risk.

The Group constitutes the Insurance Division of The Royal Bank of Scotland Group plc. The Group operates within a risk framework and benefits from services provided by specialist risk and audit teams and risk management procedures and controls which are applied across the Group. Within the Group, risk is managed at both the individual entity level and on a combined basis.

The Group is supervised on a combined basis by the Financial Services Authority ("FSA"), its lead regulator. The UK regulated entities are supervised by the FSA, the Group's business in Italy is regulated by the ISVAP and the Group's business in Germany by the BaFin.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

3.1.1 Risk management within the RBS Group

The management of risk is a fundamental management activity performed throughout all the RBS Group's operations. It is, therefore, critically important that the adequacy and effectiveness of the RBS Group's risk management processes are of the highest standard and subject to continuous review and enhancement.

The RBS Group has put in place a comprehensive risk management framework, predicated on a three lines of defence model, clearly separating risk management, risk oversight and risk assurance duties comprising:

- leadership, strategy and culture set by the board and put into effect through Executive Management;
- policies, procedures, processes and systems to execute effective risk management throughout the RBS Group;
- a comprehensive committee structure operating at RBS Group level to direct, approve and review actions taken to manage risk, replicated at the Insurance Division level where appropriate; and
- risk management functions that are independent of the business management to enforce agreed policy.

A number of high-level committees support the RBS Group's board in the effective measurement and management of risk.

3.1.2 RBS Group policy framework

The RBS Group has developed, and adopted globally, one comprehensive RBS Group Policy Framework. The aim of the RBS Group Policy Framework is to provide a simplified and effective framework to standardise the presentation and control of RBS Group policy including new policies and amendments. All employees have easy access to current RBS Group policies and policy standards through a single RBS Group intranet site.

RBS Group Policies address all the major areas of risk to the RBS Group and the standards that must be met to enable those risks to be managed in line with RBS Group's risk appetite. All RBS Group Policies must be approved by the RBS Group Executive Committee.

3.2 Direct Line Insurance Group plc specific risk governance and oversight

The Governance structure connects the business, risk function and Group audit function across the three lines of defence to provide a consistent approach to managing risk across the organisation. This includes various oversight committees which provide a robust governance and control of risk exposure.

The Direct Line Insurance Group plc Board ("the Board") oversees the business operations within the Group, ensuring competent and prudent management and the maintenance of adequate accounting and other procedures as well as compliance with statutory and regulatory obligations.

Specifically the following are key areas that the Board considers and must approve at least annually:

- the high level controls document;
- the divisional risk appetite (in relation to strategy and business plans); and
- the divisional risk profile, including the output from financial and other quantitative models (such as economic capital modelling). This encompasses the Individual Capital Assessments ("ICAs") and other capital related submissions to the supervisory authority where appropriate.

The Board has responsibility for understanding and approving the nature and level of risk assumed by the Group and the methodologies, approaches and assumptions used to identify, measure, manage,

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

monitor, report, control and mitigate such risk. As such they approve the risk appetite of the Group as a whole, by risk type and for the main regulated insurance entities within it.

Risk and Audit Committee

The Risk and Audit Committee ("RAC") is a Non Executive Committee of the Board which meets a minimum of once a quarter. The RAC operates under delegated authority from the Board with a remit specifically to review and challenge Risk and Governance in more depth on behalf of the Board. In relation to risk management, the responsibilities of the RAC are:

- to review, challenge and recommend the Risk Strategy and Risk Appetite to the Board for approval;
- to review, challenge and recommend the Enterprise Wide Risk Management Framework and other associated governance frameworks to the Board as appropriate;
- to review and challenge the risk profile including the operational adequacy and effectiveness of the risk management operating model and internal control environment across the Group; and
- to review and challenge the adequacy of the internal control framework through the receipt of Internal Audit plans and reports.

Internal Audit is responsible for providing an opinion on the effectiveness of the Risk Management framework to the RAC.

Executive Committee ("ExCo")

Ultimate responsibility for managing risk rests with the Chief Executive Officer ("CEO"), with first line control being through the Managing Directors of the business and support functions who operate a range of committees and other fora to oversee risk within their area of responsibility (e.g. pricing committees, loss ratio committees etc.)

The detailed responsibilities of the ExCo that are relevant to Risk Management are:

- to consider and determine relevant recommendations on risk management matters including risk organisation, risk strategy, risk appetite, risk policy framework and other frameworks for onward escalation to the RAC for approval as appropriate;
- to consider and approve any relevant policies, processes and procedures for the effective management of risk across the organisation;
- to consider and determine relevant recommendations on limits by risk type for onward communication to the RAC for approval as required;
- to ensure that risk and capital considerations are incorporated within the strategic planning and budgeting processes and other decision making processes as appropriate; and
- to review, consider, discuss, and understand all issues relating to the reinsurance arrangements or any other material risk mitigation strategies operated by the Group.

As part of this, the Risk function produces a range of regular reporting including a report each month to the ExCo and the Group Board that covers breaches and exceptions to risk policy, relevant management information including quantified risks and details of any new and emerging risks.

The Chief Risk Officer ("CRO") is a member of the Executive and has a reporting line to the CEO, assuring independence of the function.

Capital Management Committee

The Capital Management Committee operates as a sub-committee of, and is responsible to, the ExCo.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The role of the Capital Management Committee is to consider and recommend options that optimise the regulatory solvency capital and manage held capital appropriately in accordance with all regulatory and Board requirements and objectives, in order to maximise the capital efficiency and return on capital of the Group.

The Group also holds a Reserving Review Committee at least quarterly and a series of Loss Ratio Committees monthly, (one for each UK product category—motor, home, growth and commercial).

Compliance with Minimum Standards

The business and support functions (the First Line of Defence) must comply with the Enterprise Wide Risk Management framework, including all policies and associated minimum standards which detail the minimum requirements for managing risk within the Group. To do this each ExCo member must:

- implement such processes as it deems appropriate and in accordance with the Enterprise Wide Risk Management framework to enable the identification, assessment, management, control, reporting and mitigation of its risk exposure;
- monitor the area's compliance with the Risk Management framework;
- ensure key risks and any breaches arising are identified and escalated for review and challenge by the Risk function or higher as appropriate;
- ensure that any issues identified are managed, mitigated and resolved in a timely and appropriate manner to ensure that risk is managed within the Board's agreed risk appetite; and
- on at least a half-yearly basis, sign a control environment certificate in relation to their area of responsibility, including an assessment of their compliance with the relevant policies and minimum standards and risk management processes, following such reviews as are appropriate.

The risk function separately analyses such risk reports, aggregated as appropriate, breaches and other issues and matters to identify overall potential trends and key risks to help determine the Group's risk profile compared to its risk appetite, escalating any overall breaches and other issues for review and challenge by relevant risk fora as appropriate. Such fora, including the RAC where appropriate, are responsible for discussing, reviewing and challenging new, existing and emerging risks and issues, assisting in the formulation of action plans to mitigate them, including breaches of policy or risk appetite, and then monitoring their resolution and mitigation. As part of this, the risk function will report relevant information, including deviations, trends, key risks and actions to the ExCo and to the Board, through the RAC.

A key part of the oversight of the first line of defence's compliance with the Risk Management framework and its associated policies and procedures, is a programme of risk-based reviews and audits undertaken by the second and third lines of defence, with the results of such reviews being reported to relevant fora for consideration, to help them determine and direct future risk management activity.

3.3 Risk appetite

Risk appetite is a measure of the amount of risk that the Group is willing to accept in pursuit of its strategic objectives.

The Group's appetite for insurance risk is defined through its permissions and a Board approved statement regarding the type of business the Group will write together with a series of other statements detailing desired levels of capital, availability of earnings and stakeholder confidence. The Board reviews and approves the risk appetite framework, the high level statements and associated targets, tolerances and limits on at least an annual basis for the main risk exposures, with this being aligned to the business and risk strategy as appropriate and subject to continuous improvement including enhancing the integration of the framework with the capital model. The underlying global tolerances and limits are translated into product level targets, tolerances and units and are supported by a range of policy limits.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

3.4 Enterprise risk management

Enterprise risk management ("ERM") within the Group ensures that risk management is a forward looking discipline, focused on facilitating appropriate and fair outcomes on a consistent and reliable basis for all stakeholders. ERM provides the Group with a consistent and holistic view of risk management.

3.4.1 Risk controls

In order to consider the key risks which pose a material threat to the Group's strategic objectives, profits or capital, they are captured and monitored on the Group's High Level Risk Register ("HLRR"). The HLRR is used to determine risks subject to stress and scenario testing in quantitative modelling as well as to cross check to the risks modelled in its capital model. The potential profit variance arising from this modelling is used to assess the Group's exposure to each respective risk, with these processes subject to continuous review and refinement.

'Business As Usual' risks and their mitigating controls are documented within lower level risk assessment registers. These registers focus on business facing risks. The registers are regularly reviewed by the business owner and by the risk function.

Risks contained within these registers are subject to ongoing review and challenge to ensure that the risks are managed within the Group's risk appetite.

3.4.2 Risk and capital management modelling

The Board has ultimate responsibility for ensuring that the Group has sufficient capital to meet its liabilities as they fall due. The Group carries out detailed capital 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, in its submission of its Individual Capital Assessment ("ICA") to the Financial Services Authority ("FSA") in respect of its UK regulated entities. The ICA quantifies the insurance, market, credit, liquidity, operational and group risk that the UK regulated entities are undertaking.

The Board is closely involved in the ICA process and signs off on its assumptions and results. Specifically, the following are fundamental areas that the Board has key involvement in:

- the sign off of the parameter setting for the Dynamic Financial Analysis ("DFA") modelling;
- the review and sign off of the output from the DFA models and other quantitative modelling; and
- the review, agreement and sign off of the ICA submission to the FSA, including any surrounding documentation, policies, explanations and assumptions.

The international businesses are assessed under European Solvency I rules and Solvency I returns to the relevant supervisory bodies are reviewed and approved by the local boards, within the oversight of the Group Board.

3.5 Insurance risk

Insurance risk can arise from:

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

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The Group predominantly underwrites personal lines insurance including residential property, motor, assistance, creditor, travel and pet business. The Group also underwrites commercial risks primarily for low to medium risk trades within the small to medium enterprise ("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.

Until 6th July 2011, the Group underwrote long term insurance falling within business classes I and IV of Annex 11.1 of chapter 11 in volume 1 of the FSA Interim Prudential Sourcebook: Insurers. The products provided were mortgage life cover, fixed term life cover with critical illness, over-50's life cover and the life cover associated with the creditor business underwritten by the Group's general insurance business. Contracts were issued typically on a long-term basis, which means that the Group's liability can extend for a period ranging from five years up to fifty-two years. For creditor insurance, contracts are issued either on a monthly renewable basis (regular premium) and can be amended or cancelled by the customer at any point during the contract or cover the period of a loan (single premium). In the former case, the Group can cancel or amend the policy following a 90 day written notice period. In the latter case (these policies were withdrawn from sale in April 2009), the customer has the option to cancel the contract at any point but generally the Group is obligated for the full term of up to a maximum of 10 years but typically 3 to 5 years.

3.5.1 Reserving risk

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

Due to the uncertain nature and timing of the risks which the Group is exposed to by underwriting insurance products, it cannot precisely determine the amounts that it will ultimately pay to meet the liabilities covered by the insurance policies written or when those liabilities will be paid. As such, the Group's reserves may prove to be inadequate to cover the actual claims costs which are experienced, particularly when the settlement of liability or payments of claims may not occur until well into the future, for example, and in particular, for bodily injury claims.

The Group maintains technical provisions or reserves to cover the estimated cost of future claims payments and related administrative expenses with respect to losses or injuries which have been incurred but have not been fully settled at the balance sheet date or which may occur in the future against insurance policies which have already been written prior to the balance sheet date. This includes losses or injuries that have been reported to the Group and those that have not yet been reported. The claims reserves represent estimates of all expected future payments, including related expenses, to bring every claim which has occurred prior to the balance sheet date whether reported or not, to final settlement, and the premium provisions represent the higher of the unexpired premiums or the estimated ultimate cost of the Group's exposure to claims and associated administration expenses which occur after the balance sheet date against business which was written prior to such date.

The Group estimates reserves using a range of actuarial and statistical projections and assumptions across a range of variables such as the time required to learn of and settle claims, facts and circumstances known at a given time, estimates of trends in the number of claims or claims of certain types, estimated inflation in claims severity and expected future claims payment patterns. Estimates are also made in respect of other variable factors including changes in the legal, social, economic and regulatory environments, results of litigation, changes in rehabilitation and mortality trends, inflation in medical care costs, future earnings inflation, the cost of repairs and replacement, general economic conditions and estimated future receipts from third parties such as salvage, subrogation and reinsurance recoveries as well as changes in internal claims handling processes.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

For claims which will take several years to settle, mainly bodily injury, illness and liability (both public and employer's liability), the Group estimates such provisions based on past experience as well as consideration of known or potential future changes. Unexpected events, such as changes in regulation, legislation or new court cases, may increase the frequency and/or severity of insurance claims substantially more than anticipated at the time the insurance policies were priced or provisions were set. The Group's employer's liability business is also exposed to the risk of disease related claims in respect of currently unknown exposures being identified at a (much later) future date.

While most of the Group's technical reserves are held on an undiscounted basis and, therefore, do not allow for the investment income which will be earned on the reserves after the balance sheet date up until the claims are fully settled, the reserves held in respect of periodical payment orders ("PPOs") are held on a discounted basis. As such, the size and nature of the PPO reserves are exposed to the risk of changes in the timing of future cash flows or assumed discount rate / level of investment income. The Group subjects its reserves to independent external actuarial peer review on a periodic basis.

The Group's technical reserves are particularly susceptible to potential retrospective changes in legislation and new court decisions. For example, a change in the 'Ogden discount rate', which is the discount rate set by the UK government to be used (among other things) to calculate lump sum awards in bodily injury cases, would impact all relevant claims settled after that date, regardless of whether the insurance to which the claim relates was priced on that basis or not.

The recent increase in the utilisation of PPOs to settle bodily injury claims makes the estimation of technical reserves increasingly complex and uncertain due to the increased range of assumptions required, such as the future propensity of such settlement methods, estimated mortality trends for impaired lives, payment patterns, investment income and the impact of reinsurance recoveries which will occur many years into the future with a resultant increase in the associated credit or other non-payment risk. The fact that these claims take many years to ultimately settle increases the uncertainty around their estimation.

Reserving risk is controlled through a range of processes, the most significant ones being:

- regular periodic reviews of the claims and premium / liability adequacy reserves for the main classes of business by the internal actuarial team;
- the use of external actuaries to periodically peer review the actuarial best estimate reserves on classes reviewed internally, and to complete external actuarial reviews on the vast majority of the remaining reserves;
- oversight of the reserving process by relevant senior management and the Group Board; and
- 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.

3.5.2 Claims management risk

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

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

Each member of staff has a specified handling authority, with controls preventing them handling or paying claims outside of their authorities, 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 management.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

A process is in place in the UK to deal with severe weather and other catastrophic events, known as the SWEP ("Severe Weather Event Plan"). SWEP is the collective name given to an incident which significantly impacts the volume of claims reported to the Group's claims functions. The plan covers SWEP triggers, stages of incident, operational impact, communication, and management information monitoring of the impact.

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

3.5.3 Underwriting and pricing risk: General Insurance

Underwriting and pricing risk is the risk that inappropriate business will be written and/or inappropriate prices charged. The classes and sectors of business written, the underwriting criteria, and relevant limits, define underwriting risk appetite.

The Group manages this risk through a wide range of processes and fora, some of which include:

- underwriting guidelines which exist for all business transacted restricting the types and classes of business that may be accepted;
- exception reports and other underwriting monitoring tools;
- comprehensive internal quality assurance programmes;
- pricing policies which are set by management and implemented through pricing committees by product line and by brand;
- central control, within pricing and underwriting teams, of policy wordings and any subsequent changes;
- the insurance risk framework that involves, among other things, regular minuted meetings where all aspects of insurance risk are discussed, and additional meetings where detailed pricing, claims and reserving data and information are examined and discussed;
- weekly monitoring within the business of key performance indicators by product and brand;
- formal monthly monitoring and reporting to the Executive, by product and brand; and
- annual budgeting and quarterly re-forecasting, signed off by the ExCo.

The following paragraphs explain the **frequency** and **severity** of specific risks under the key classes that the Group is exposed to:

a) Motor insurance contracts

The causes of motor claims are primarily theft of, or from, the vehicle, accidental damage to the vehicle, third-party property damage and third-party bodily injury. To meet statutory requirements, policies of insurance written in the UK provide unlimited exposure for policyholders' liability at law for third-party bodily injury and reinsurance is purchased for the unlimited element over a suitable deductible. Motor liability insurance policies underwritten by the international businesses are governed by local laws and liability limits are capped (except for green card business where liability is unlimited). Reinsurance is purchased to reduce the retention to substantially below the prescribed limits.

Claims experience is subject to variation based on a significant number of factors, such as the ages and experience of the drivers, the type of vehicle, the area and weather events. Contracts are typically issued on an annual basis, which means that 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 terms and conditions including the excess or both.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

b) Residential property insurance contracts

The major claim perils for residential property insurance are theft, flood, escape of water, fire, storm, subsidence, liability and various types of accidental damage.

All contracts are typically written on an annual basis which means the Group's commitment is usually for a 12-month period, after which the Group can decline to renew or can impose special renewal terms through increased premiums or amending the terms and conditions including the excess or both.

c) Commercial motor insurance contracts

Commercial motor insurance contracts can include individual commercial vehicles, fleets of vehicles for businesses or motor trade risks. The causes of commercial motor claims are primarily theft of, or from, the vehicle, personal accident, accidental damage to the vehicle, third-party property damage and third-party bodily injury. To meet statutory requirements, policies of insurance in the UK provide unlimited exposure for policyholders' liability at law for third-party bodily injury and reinsurance is purchased for the unlimited element over a suitable deductible. Motor liability insurance policies underwritten by the international businesses are governed by local laws and liability limits are capped. Reinsurance is purchased to reduce the retention to substantially below the prescribed limits.

Claims experience is subject to variation based on a wide number of factors, the principal ones are the ages and experience of the drivers, type of vehicles and use. Contracts are typically issued on an annual basis, which means that the Group's liability extends to a 12-month period, after which the Group is entitled to decline to renew or can impose renewal terms by amending the premium, terms, excesses or a combination.

d) Commercial other insurance contracts

Commercial claims come mainly from property loss or damage, business interruption and losses arising from the negligence of the Insured (liability insurance).

Property loss/damage claims come from causes such as fire, theft, storm, flood and other defined perils. Business interruption losses come from the loss of income, revenue and/or profit as a result of the cause of the property damage claim. These covers are generally written on a sum insured basis based on the values at risk.

Liability insurance can be broken down between employers' liability and public/products liability. The first covers employees for injury caused as a result of the insured's negligence. Public/products liability indemnifies the insured against any claims made by a third party for injury and/or damage as a result of the Insured's negligence. Employers liability has a standard limit of indemnity of £10 million plus authorised costs, but can be increased to £25 million for larger policyholders on request.

Public/products liability generally has a limit of up to £5 million, but can be increased to £10 million on request.

Insurance contracts are typically issued on an annual basis which means that the Group's liability is limited to a 12-month period, after which the Group can decline to renew the policy or can impose renewal terms such as increasing the premium or applying special terms such as an increased policy excess. However, as liability insurance is written on an occurrence basis, these covers are still subject to claims that manifest over a substantial period of time, but where the loss was in existence during the life of the policy (for example long-tail disease claims such as asbestosis).

e) Creditor insurance contracts

Creditor insurance contracts are designed to cover payments on secured or unsecured lending, whether for individuals or, in certain circumstances, for sole traders and nominated individuals in small commercial companies.

The causes of creditor insurance claims are loss of income through accident, sickness, unemployment or, for some coverages/policies, death.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The largest influences on claims experience are the economic environment and the risk of a pandemic. Contracts are issued either on a monthly renewable basis (regular premium) and can be amended or cancelled by the customer at any point during the contract, or by the Group following a 90-day written notice period or are issued for the full term of the loan (single premium policies were withdrawn from sale in April 2009). In the latter case, the customer has the option to cancel the contract at any point but generally the Group is obligated for the full term of up to a maximum of 10 years but typically 3 to 5 years.

f) Special Risks contracts

Loss reserve movements in the discontinued special risks portfolio are largely covered by an indemnity from Axa Winterthur.

The portfolio comprises non-standard risk schemes and there are large variations in policy coverage across the range of schemes. The wide variety of risks covered means that there is very little standardisation of terms between schemes. Administrators are required to provide updates on the activity on individual schemes through regularly submitted bordereaux. These provide details of claims for the period as well as exposure details such as the mix by policy term. Scheme performance is reviewed regularly by external actuaries and reserves are adjusted accordingly. This involves best estimates based on the development of earning patterns by scheme and ultimate loss ratios based on available exposure information. This requires analysis of the incidence of exposure in the underlying policies throughout the policy term.

g) Travel insurance contracts

The main causes of travel insurance claims are medical expenses incurred as a result of the illness of or accident to the insured while on a trip, loss or theft of their personal possessions and cancellation of the trip before departure or curtailment during it due to illness or accident of the insured or a close relative.

Policies can either be on a single trip, or on an annual basis where all trips taken in a 12-month period are covered. Either way the risk factors are the age and state of health of the insured, the destinations of trips, the activities to be undertaken on the trips, and the durations.

h) Pet insurance contracts

The main cause of claim is the incurring of vet's fees to treat a sick dog or cat. Vet fee inflation is an issue that the Group deals with by rate and excess increases. Liability to third parties for accidents caused by dogs is also covered. Policies are renewable either annually or monthly. The species (cat or dog), age and breed of the animal are prime risk factors, as well as the postcode of its owner.

i) Assistance contracts

Assistance contracts comprise motor vehicle rescue and home response 24 ("HR24"). The major causes of assistance claims are vehicle breakdown or failure to start (rescue) or the need for emergency repairs of heating, drainage and plumbing ("HR24"). Contracts are typically issued on an annual basis which means that the Group's liability usually extends for a period of 12 months.

The following paragraphs explain the **source of uncertainty** in respect of the specific key classes of business:

a) Motor insurance contracts (both private and commercial contracts)

There are various sources of uncertainty which will impact the Group's experience under motor insurance, including operational risk, reserving risk, premium rates not matching claims inflation rates, (particularly for bodily injury claims where frequency and severity are carefully monitored), the social, economic and legislative environment and reinsurance failure risks. Legislative risks for example in the UK, periodical payment orders (PPOs) under the Courts Act and the associated longevity and discounting risks, and reviews of the Ogden tables used when setting lump sum bodily injury claim awards, including the associated discount rate, are all carefully monitored. The Group has documented risk policies, coupled with governance frameworks to oversee and control these risks and hence minimise the losses.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

b) Property insurance contracts

The major source of uncertainty in the performance of the Group's property account is the volatility of the weather. Weather in the UK can affect the following causes of claims: flood, storm, escape of water following freezing (burst pipes) and subsidence. The Group maintains detailed, documented and active flood and subsidence strategies in order to control these exposures. Long term exposure to potential climate change and associated risks is also closely monitored.

Over a longer period the strength of the economy is also a factor. During tougher times, as more businesses close down and unemployment increases, arson, theft and similar types of claims tend to increase.

There are many other sources of uncertainty which include operational, reserving, pricing and reinsurance issues. However, the Group has documented risk policies, coupled with governance frameworks to oversee and control these risks and hence minimise the losses.

c) Commercial other insurance contracts

There are a number of uncertainties which will impact the Group's general liability account. These include changes in the social, economic and legislative environment and, in particular, court judgments and legislation (for example, periodical payment orders under the Courts Act, a review of the Ogden tables used by courts when setting bodily injury claim values), significant events (for example, terrorist attacks), and any emerging new heads of damage or types of claim that are not envisaged when the policy is written. This includes exposure to disease claims not realised / anticipated at the inception of the policy where exposure occurs during the policy period but symptoms and hence claims do not occur for many years into the future.

There are many other sources of uncertainty which include operational, reserving and reinsurance issues. However, the Group has documented risk policies, coupled with governance frameworks to oversee and control these risks and hence minimise the losses.

d) Creditor insurance contracts

The main source of uncertainty is the economic environment. A recession could lead to an increased number and cost of unemployment, accident and sickness claims. The policies are also exposed to increased death claims under the life cover element in the light of a severe pandemic.

e) Special Risks contracts

The wide variety of risks covered means that there are a significant number of uncertainties which affect the underwriting performance of the special risks portfolio arising from the economic, social and legislative environment. Reserving risk is monitored through regular reviews by external actuaries. The Group's exposure is mitigated through the indemnity from Axa Winterthur.

f) Travel insurance contracts

The main sources of variability are large individual claims or events such as motor accidents or coach crashes, natural catastrophes or acts of terrorism. The Group has documented risk policies, coupled with governance frameworks to oversee and control these risks and hence minimise the losses.

g) Pet insurance contracts

Large liability claims are few and far between, but there are many other sources of uncertainty which include operational, reserving, pricing and social and economic issues including vet fees inflation. The Group has documented risk policies and relevant frameworks to oversee and control these risks and hence to mitigate the losses.

h) Assistance contracts

There are various sources of uncertainty which impact the Group's experience under assistance contracts. Adverse weather increases the number of both vehicle breakdown claims and home response

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

claims due to the increased strain on heating and plumbing systems. The strength of the economy is also a factor. During times of economic difficulties, vehicle and property maintenance tends to decline, increasing the risk of breakdown and failure. The Group's documented risk policies and governance frameworks oversee these risks.

The Group's ability to successfully quantify risk exposure, and as a result, price insurance products successfully, is subject to risks and uncertainties, including uncertainties in claims inflation estimation (including its progression), from bodily injury claims in particular; unanticipated legal and regulatory changes and costs; changes in social, market or consumer trends and behaviours, including claimant behaviour; potential inaccuracies in the data collected from internal and external parties and/or used within the modelling and pricing processes; incorrect or incomplete analysis of data; potentially inaccurate or inappropriate policy terms and conditions; inappropriate or incomplete purchase of reinsurance; changes in the internal operating environment within the Group; the selection of inappropriate pricing methodologies; and the uncertainties inherent in estimates and assumptions, including those used throughout the pricing and underwriting processes.

3.5.4 Underwriting and pricing risk: Life insurance

The life business was closed to new business in July 2011.

For contracts where death or critical illness is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics or wide spread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected.

For contracts with fixed benefits and fixed future premiums, there are no mitigating terms and conditions that reduce the insurance risk accepted.

For contracts with reviewable premiums a mitigating factor is the reviewable nature of the premium. Under the terms of the policy the retail premium can be adjusted to reflect claims experience, developments in medical technology and diagnosis and other related expenses.

The table below presents total benefits insured figures, gross and net of re-insurance.

Benefits assured for life assured business at 31 December:

	Total benefits insured	
	Before reinsurance £ Million	After reinsurance £ Million
2011	16.1	2.1
2010	17.3	2.2
2009	18.3	2.3

Uncertainty in the estimation of future benefits and premium receipts for long-term insurance contracts arises from the unpredictability of long-term changes in overall levels of mortality and morbidity, and lapse rates.

The Group uses appropriate base tables of standard mortality and morbidity according to the type of contract being written and the territory in which the insured person resides. Investigations into the Group's recent experience, in conjunction with reviews of the continuous mortality and morbidity investigations performed by independent actuarial bodies, are carried out and a best estimate of the expected mortality and morbidity for the future is derived.

Assumptions

The Group writes only non-profit long-term business where the equity owners are entitled to 100% of the profits. The gross premium method of actuarial valuation is used. This makes explicit assumptions for

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

interest and discount rates, mortality and morbidity, persistency and future expenses. Assumptions are reviewed annually against actual experience and industry and economic trends.

The key assumptions used for the life insurance contracts, other than creditor insurance business, disclosed in this note are as follows:

Mortality and morbidity

Appropriate base tables of standard mortality and morbidity are chosen depending on the type of contract. An investigation into the Group's recent experience, in conjunction with a review of the continuous mortality and morbidity investigations performed by independent actuarial bodies, is carried out and an appropriate level of the base table is derived.

Investment returns

A valuation discount rate of 1.2% net of tax has been used (2010 and 2009: 2.5%).

Renewal expense level and inflation

The Group's current level of expenses, together with a margin for prudence, is taken as an appropriate expense base and an expense inflation rate of 5.5% (2010 and 2009: 4.0%) is applied. This was adjusted in 2011 to allow for the inherent expense risk associated with books of business in run-off.

For regular premium creditor insurance business the Group holds a multiple of premium as the reserve. For single premium creditor insurance business the reserve is taken as a proportion of the single premium, where the proportion reflects the outstanding term remaining on the contract.

Lapses

For critical illness policies the Group has used a lapse rate of 4.5% per annum (2010 and 2009: 4.5%), when net cash flows are negative and a low lapse rate is prudent. Otherwise a lapse rate of 15.5% per annum (2010 and 2009: 15.5%) is used. For all other policies, excluding over 50's polices and creditor, the Group has used a lapse rate of 1.5% per annum (2010 and 2009: 1.5%), when net cash flows are negative and a low lapse rate is prudent. Otherwise a lapse rate of 12.5% per annum (2010 and 2009: 12.5%) is used.

Change in assumptions during the year

The following estimates and assumptions used in determining assets and liabilities for insurance contracts were changed, and had the following effect on profit recognised for the year ended 31 December 2011:

	Effect on profit 2011 £ Million	Effect on profit 2010 £ Million	Effect on profit 2009 £ Million
Change in valuation interest rate	(1.4)	—	—
Mortality/Morbidity for insurance contracts	—	(0.4)	0.8
Expenses	(1.1)	(0.1)	(0.1)
Lapse rate	—	—	(0.5)
	(2.5)	(0.5)	0.2

Life insurance results are inherently uncertain, driven by actual experience being different to modelled assumptions, exacerbated by the long term nature of the underlying exposure.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

3.5.5 Reinsurance risk

The Group uses reinsurance:

- to protect the insurance results against low frequency, high severity losses through the transfer of catastrophe claims volatility to reinsurers;
- to 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;
- to reduce the Group's capital requirements; and
- to transfer risk that is not within the Group's current risk retention strategy.

Reinsurance is essentially a swap whereby the Group will cede away insurance risk to reinsurers but in return assume back credit 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 credit risk are subject to a Credit Risk Approval Process. The Group's leading counterparty exposures are analysed on a monthly basis where utilisation is monitored against agreed individual reinsurer limits. These limits represent the accumulated credit risk for all group underwriting entities. 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.

Reinsurance risk arises from a failure of reinsurance to control exposure to losses, to reduce volatility or to protect capital.

3.5.6 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 243 year combined windstorm and coastal inundation loss. This cover protects the UK companies underwriting property insurance. The combined retained loss at 31 December 2011 is £125 million which has been modelled as a 1 in 11 year return period loss. 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 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 are contracted with, within the desired credit rating range.

3.6 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. Further details on financial risk in respect of reinsurance can be found in note 3.5.5 on reinsurance risk.

The strategic asset allocation within the investment portfolio is agreed by the UK and international Investment Committees. The Investment Committees determine high level policy and controls, covering such areas as safety, liquidity and performance. They meet at least half-yearly 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 Committees are effected through the Funds Management Committee ("FMC").

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The objectives set out in the Investment Policy are:

- to maintain safety of the portfolio's principal both in economic terms and from an accounting and reporting perspective;
- to maintain sufficient liquidity to provide cash requirements for operations; and
- to maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the Investment Guidelines.

3.6.1 Market risk

Market risk encompasses any adverse movement in the value of assets as a consequence of market movements such as interest rates, credit spreads, foreign exchange rates and property valuations.

The Group is exposed to market risk in both the value of its liabilities and the value of assets held. The Group does not hold investments for trading purposes. Exposure to market risk in the investment portfolio is managed in accordance with the guidelines set out in the Group's Investment Policy as detailed above.

In the UK, the Group assesses the financial impact from changes in market risk through value at risk modelling and stress testing adopted as part of the Individual Capital Assessment (ICA) process. These tests are designed to consider the impact on capital arising from various scenarios based on changes in the financial circumstances and budget assumptions.

Interest rate risk

Interest rate risk arises primarily from the Group's investments in long-term debt and fixed income securities, which are exposed to fluctuations in interest rates.

For claims reserves, the Group has exposure to interest rate risk due to the PPO reserves that are discounted.

A table showing the sensitivity of profits to changes in interest rates is included below.

Spread risk

Spread risk results from the sensitivity of the value of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure.

The main exposure to spread risk is generated by the investment portfolio.

Currency risk

The principal currency risk exposure arises from the Group's foreign subsidiary investment. The currency risk is hedged through forward foreign exchange contracts and are normally for a duration of 90 days. The derivatives are reviewed to ensure they continue to be effective on a monthly basis. Within the UK business investment portfolio an investment fund includes Euro and US Dollar denominated bonds, hedged back to sterling. As at 31 December 2011 the value of this holding was £382.8 million (2010: £370.9 million; 2009: £367.3 million). The Group has other financial risk exposures which are minimal.

For claims and premium reserves there is very little foreign exchange risk as the majority of claims are denominated in the domiciled currency of operation of the Group's companies except some foreign travel risks (motor and travel policies).

All other financial assets and liabilities are predominantly denominated in sterling and do not bear any exposure to currency risk.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

Property price risk

The Group is subject to property price risk due to its holdings of investment properties. These properties are all based in the UK and are subject to the asset admissibility rules laid down by the FSA.

A table showing the sensitivity of profits to changes in property prices is included below.

Equity risk

The Group holds no equities within its investment portfolios.

Sensitivity analysis

Some results of sensitivity testing are set out below. For each sensitivity test the impact of a reasonably possible change in a single factor is shown, with other assumptions left unchanged.

Sensitivity factor	Description of sensitivity analysis
Market prices	The impact of a change in market prices on financial investments by +/− 20%.
Interest rate and investment return	The impact of a change in market interest rates by +/− 1% (e.g. if a current interest rate is 2%, the impact of an immediate change to 1% or 3%).
Periodical payment order liabilities	The impact of a change in the rate of interest used for the calculation of present values is assumed to change by +/− 1%.
Investment funds and property market values	The impact of a change in other investment funds and property market values by +/− 15%.
Expenses	The impact of an increase in ongoing administrative expenses and the loss adjustment expenses provision by 10%. This is calculated on the basis of the business of the Group for the full year.
Loss ratios	The impact of an increase in loss ratios by 5%, which assumes no large losses triggering reinsurance recoveries. This is calculated on the basis of the business of the Group for the full year.

Sensitivity at 31 December 2011

Increase/(decrease) in income statement before tax (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	—	—	9.2	(9.2)	174.8	(252.2)	67.8	(67.8)	(81.9)	(213.2)
Net of reinsurance	—	—	9.2	(9.2)	106.5	(152.2)	67.8	(67.8)	(81.9)	(213.2)

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

Impact before tax on total equity (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	1,521.6	(1,521.6)	(233.2)	233.2	174.8	(252.2)	67.8	(67.8)	(81.9)	(213.2)
Net of reinsurance	1,521.6	(1,521.6)	(233.2)	233.2	106.5	(152.2)	67.8	(67.8)	(81.9)	(213.2)

Sensitivity at 31 December 2010

Increase/(decrease) in income statement before tax (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	—	—	12.7	(13.0)	160.9	(234.8)	68.2	(68.2)	(73.7)	(248.7)
Net of reinsurance	—	—	12.7	(13.0)	101.4	(143.8)	68.2	(68.2)	(73.7)	(248.7)

Impact before tax on total equity (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	1,499.2	(1,499.2)	(159.1)	158.9	160.9	(234.8)	68.2	(68.2)	(73.7)	(248.7)
Net of reinsurance	1,499.2	(1,499.2)	(159.1)	158.9	101.4	(143.8)	68.2	(68.2)	(73.7)	(248.7)

Sensitivity at 31 December 2009

Increase/(decrease) in income statement before tax (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	—	—	22.4	(22.9)	N/A*	N/A*	66.8	(66.8)	(74.0)	(256.4)
Net of reinsurance	—	—	22.4	(22.9)	N/A*	N/A*	66.8	(66.8)	(74.0)	(256.4)

Impact before tax on total equity (£ Million)

	Market prices		Interest rate and investment return		Periodical payment order liabilities		Investment funds and property market values		Expenses	Loss ratio
	+20%	−20%	+1%	−1%	+1%	−1%	+15%	−15%	+10%	+5%
Gross of reinsurance	1,395.9	(1,395.9)	(207.7)	232.4	N/A*	N/A*	66.8	(66.8)	(74.0)	(256.4)
Net of reinsurance	1,395.9	(1,395.9)	(207.7)	232.4	N/A*	N/A*	66.8	(66.8)	(74.0)	(256.4)

* The sensitivity analysis data for periodical payment order liabilities in 2009 is not available.

Limitations of sensitivity analysis

The above tables show the effect of a change in a key assumption while other assumptions remain unchanged. In reality, there is a correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

3.6.2 Credit risk

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

The objective of the Credit Risk Policy and supporting Minimum Standards is to document the control processes by which the Group is able to identify, monitor, measure, manage, control and mitigate the level of credit risk effectively. The credit risk control environment is summarised below:

Credit risk forum

The primary responsibility of this forum is to ensure that all aspects of credit risk within the Group are identified, monitored and measured.

Credit risk sanctioning committee

The primary responsibility of this committee is to approve new and increased credit risk limits in excess of business area credit authorities but within the committee's credit authority.

Monitoring and reporting

Relevant business units monitor the level of their actual credit exposure and measure this against approved credit terms and limits.

The main sources of credit risk for the Group are as follows:

- Investment counterparty—this arises from the investment of monies in the range of investment vehicles permitted by the Investment Policy.
- Reinsurance Recoveries—credit exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed. The Courts Act 2003, implemented in April 2005, gave the Courts the power to award PPOs in place of lump sum awards to cover the future costs element of claims (i.e. loss of future earnings and/or cost of future care). PPOs have the potential to increase the ultimate value of a claim and by their very nature, significantly increase the length of time to reach final settlement. Consequently any assumed (reinsurance) credit risk could be increased both in terms of quantum and longevity.

The following table provides information regarding the carrying value of financial and insurance assets that are neither past due nor impaired, the ageing of financial assets that are past due but not impaired and financial assets that have been impaired.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

At 31 December 2011

	Neither past due nor impaired £ Million	Past due 1 - 30 days £ Million	Past due 31 - 60 days £ Million	Past due 61 - 90 days £ Million	Past due more than 91 days £ Million	Carrying value in the balance sheet £ Million	Financial assets that have been impaired £ Million
Debt securities (note 24)	7,607.2	—	—	—	0.7	**7,607.9**	3.5
Deposits with credit institutions (note 24 & 26)	3,050.3	—	—	—	—	**3,050.3**	—
Insurance liabilities—reinsurance asset (note 22)	741.6	—	—	—	—	**741.6**	53.9
Cash at bank and in hand (note 26)	201.9	—	—	—	—	**201.9**	—
Insurance and other loans and receivables (note 25)	1,223.1	22.4	3.5	2.1	1.8	**1,252.9**	0.5
Total assets bearing credit risk	**12,824.1**	**22.4**	**3.5**	**2.1**	**2.5**	**12,854.6**	**57.9**

At 31 December 2010

	Neither past due nor impaired £ Million	Past due 1 - 30 days £ Million	Past due 31 - 60 days £ Million	Past due 61 - 90 days £ Million	Past due more than 91 days £ Million	Carrying value in the balance sheet £ Million	Financial assets that have been impaired £ Million
Debt securities (note 24)	7,496.2	—	—	—	—	**7,496.2**	3.5
Deposits with credit institutions (note 24 & 26)	2,941.4	—	—	—	—	**2,941.4**	—
Insurance liabilities—reinsurance asset (note 22)	660.9	—	—	—	—	**660.9**	9.2
Cash at bank and in hand (note 26)	234.3	—	—	—	—	**234.3**	—
Insurance and other loans and receivables (note 25)	1,551.8	32.4	4.8	3.7	13.5	**1,606.2**	1.6
Total assets bearing credit risk	**12,884.6**	**32.4**	**4.8**	**3.7**	**13.5**	**12,939.0**	**14.3**

At 31 December 2009

	Neither past due nor impaired £ Million	Past due 1 - 30 days £ Million	Past due 31 - 60 days £ Million	Past due 61 - 90 days £ Million	Past due more than 91 days £ Million	Carrying value in the balance sheet £ Million	Financial assets that have been impaired £ Million
Debt securities (note 24)	6,979.3	—	—	—	—	**6,979.3**	—
Deposits with credit institutions (note 24 & 26)	2,905.3	—	—	—	—	**2,905.3**	—
Insurance liabilities—reinsurance asset (note 22)	517.6	—	—	—	—	**517.6**	1.8
Cash at bank and in hand (note 26)	123.5	—	—	—	—	**123.5**	—
Insurance and other loans and receivables (note 25)	1,671.5	46.3	6.1	4.1	4.8	**1,732.8**	3.5
Total assets bearing credit risk	**12,197.2**	**46.3**	**6.1**	**4.1**	**4.8**	**12,258.5**	**5.3**

The Group does not hold any collateral as security.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

There were no material financial assets that would have been past due or impaired had the terms not been renegotiated.

The following table analyses the credit quality of debt securities (note 24) that are neither past due nor impaired by type of asset.

At 31 December 2011

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	AFS—Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
AAA rated	3,414.9	96.4	637.0	27.4	4,175.7	206.8	3,968.9
AA and above	57.0	279.9	434.0	—	770.9	67.2	703.7
A and above	9.2	1,377.3	858.1	11.3	2,255.9	9.5	2,246.4
BBB− and above	—	287.7	82.4	4.7	374.8	—	374.8
BB+ and below	—	—	23.3	—	23.3	—	23.3
Unrated	—	—	7.3	—	7.3	—	7.3
Total by debt security type	**3,481.1**	**2,041.3**	**2,042.1**	**43.4**	**7,607.9**	**283.5**	**7,324.4**

At 31 December 2010

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	AFS—Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
AAA rated	3,011.4	62.9	1,148.2	—	4,222.5	476.2	3,746.3
AA and above	15.8	227.3	855.6	24.2	1,122.9	9.3	1,113.6
A and above	4.3	855.4	1.053.9	11.3	1,924.9	10.5	1,914.4
BBB− and above	—	107.6	95.8	9.3	212.7	—	212.7
BB+ and below	—	—	11.9	—	11.9	—	11.9
Unrated	—	—	1.3	—	1.3	—	1.3
Total by debt security type	**3,031.5**	**1,253.3**	**3,166.8**	**44.8**	**7,496.2**	**496.0**	**7,000.2**

At 31 December 2009

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	AFS—Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
AAA rated	1,665.6	625.5	3,192.8	23.2	5,507.1	684.1	4,823.0
AA and above	12.0	132.8	539.9	—	684.7	—	684.7
A and above	8.4	312.7	390.2	—	711.3	2.2	709.1
BBB− and above	—	—	53.1	—	53.1	—	53.1
BB+ and below	—	—	23.1	—	23.1	—	23.1
Unrated	—	—	—	—	—	—	—
Total by debt security type	**1,686.0**	**1,071.0**	**4,199.1**	**23.2**	**6,979.3**	**686.3**	**6,293.0**

Bank debt securities for 31 December 2011 can be further analysed as Secured (£418.8 million), Unsecured (£1,357.1 million), Subordinate (£193.9 million) and Certificates of Deposit (£72.3 million).

The following table analyses the credit quality of financial and insurance assets that are neither past due nor impaired by type of asset, excluding debt securities. The table includes reinsurance exposure, after provision. Note 3.6.2 details the Group's approach to reinsurance credit risk management.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

At 31 December 2011

	AAA £ Million	AA+ to AA− £ Million	A+ to A− £ Million	BBB £ Million	Not rated £ Million	Total £ Million
Deposits with credit institutions (note 24 & 26)	637.1	398.0	1,622.4	10.0	—	2,667.5
Insurance liabilities—reinsurance asset (note 22)	73.5	484.9	189.1	—	(5.9)	741.6
Cash at bank and in hand (note 26)	—	—	201.9	—	—	201.9
Insurance and other loans and receivables (note 25)	1.2	23.7	143.9	—	1,084.1	1,252.9
Total	**711.8**	**906.6**	**2,157.3**	**10.0**	**1,078.2**	**4,863.9**

At 31 December 2010

	AAA £ Million	AA+ to AA− £ Million	A+ to A− £ Million	BBB £ Million	Not rated £ Million	Total £ Million
Deposits with credit institutions (note 24 & 26)	631.3	1,220.3	718.9	—	—	2,570.5
Insurance liabilities—reinsurance asset (note 22)	28.9	337.1	256.3	—	38.6	660.9
Cash at bank and in hand (note 26)	—	—	234.2	—	0.1	234.3
Insurance and other loans and receivables (note 25)	2.3	28.2	220.3	—	1,355.4	1,606.2
Total	**662.5**	**1,585.6**	**1,429.7**	**—**	**1,394.1**	**5,071.9**

At 31 December 2009

	AAA £ Million	AA+ to AA− £ Million	A+ to A− £ Million	BBB £ Million	Not rated £ Million	Total £ Million
Deposits with credit institutions (note 24 & 26)	604.7	511.8	1,421.6	—	—	2,538.1
Insurance liabilities—reinsurance asset (note 22)	25.5	238.8	203.4	—	49.9	517.6
Cash at bank and in hand (note 26)	—	0.1	123.3	—	0.1	123.5
Insurance and other loans and receivables (note 25)	1.6	26.4	113.1	1.6	1,590.1	1,732.8
Total	**631.8**	**777.1**	**1,861.4**	**1.6**	**1,640.1**	**4,912.0**

An investment in other investment funds which have a value of £382.8 million as at 31 December 2011 (2010: £370.9 million; 2009: £367.3 million) is not included in the "Deposits with credit institutions" above, as the disclosure of the funds held by credit is considered to be impractical.

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

3.6.3 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/cash without suffering a substantial loss on realisation.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

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. Compliance is monitored both in respect of the internal policy and the regulatory requirements of local regulators.

The Group performs liquidity risk stress testing as part of its ICA process in the UK. These tests are designed to assess the Group's liquidity requirements in order to meet claims and other liabilities in a number of different extreme event scenarios and compare this requirement against the liquidity available from its investment portfolio and other assets. In all of the events considered the Group is comfortably able to meet its liabilities as they fall due.

In the event that one or more liquidity stresses or scenarios crystallises, or should any other event that may impact liquidity occur, the Group seeks to ensure that the event has a rapid and controlled response. A Liquidity Crisis Management Team will be formed to assess the nature and extent of the threat and to develop an appropriate response.

Analysis of maturity of debt securities

	2011 £ Million	2010 £ Million	2009 £ Million
Within 1 year	818.8	1,876.1	1,230.4
1 - 3 years	2,808.3	1,753.7	2,428.5
3 - 5 years	2,140.0	2,109.7	1,325.9
5 - 10 years	1,576.4	1,256.4	1,321.2
Over 10 years	264.4	500.3	673.3
Total	**7,607.9**	**7,496.2**	**6,979.3**

Analysis of maturity of liabilities

For each category of insurance and financial liabilities, the following table shows the gross liability analysed by remaining duration. The total liability is split by remaining duration in proportion to the cash-flows expected to arise during that period.

At 31 December 2011

	Total £ Million	Within 1 year £ Million	1 - 3 years £ Million	3 - 5 years £ Million	5 - 10 years £ Million	Over 10 years £ Million
Insurance liabilities (note 29)	6,509.0	2,182.0	1,934.6	887.5	834.5	670.4
Borrowings (note 31)	317.9	71.5	205.0	—	11.3	30.1
Trade and other payables including insurance payables (note 34)	910.2	910.2	—	—	—	—
Total	**7,737.1**	**3,163.7**	**2,139.6**	**887.5**	**845.8**	**700.5**

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

At 31 December 2010

	Total £ Million	Within 1 year £ Million	1 - 3 years £ Million	3 - 5 years £ Million	5 - 10 years £ Million	Over 10 years £ Million
Insurance liabilities (note 29)	6,941.4	2,400.0	2,001.7	939.2	680.3	920.2
Borrowings (note 31)	327.1	296.0	—	—	—	31.1
Trade and other payables including insurance payables (note 34)	698.0	698.0	—	—	—	—
Total	**7,966.5**	**3,394.0**	**2,001.7**	**939.2**	**680.3**	**951.3**

At 31 December 2009

	Total £ Million	Within 1 year £ Million	1 - 3 years £ Million	3 - 5 years £ Million	5 - 10 years £ Million	Over 10 years £ Million
Insurance liabilities (note 29)	5,928.5	2,190.5	1,937.7	947.2	659.1	194.0
Borrowings (note 31)	285.2	253.2	—	—	—	32.0
Trade and other payables including insurance payables (note 34)	801.0	801.0	—	—	—	—
Total	**7,014.7**	**3,244.7**	**1,937.7**	**947.2**	**659.1**	**226.0**

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

3.6.4 Investment concentration risk

Investment concentration risk 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.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The distribution of the debt securities held by geographical area in 2011, were as follows:

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
Australia	—	74.6	164.9	38.3	277.8	—	277.8
Austria	2.8	—	10.0	—	12.8	—	12.8
Belgium	6.9	2.7	4.4	—	14.0	—	14.0
Canada	68.1	16.6	1.8	—	86.5	—	86.5
Cayman Islands	—	2.8	—	—	2.8	—	2.8
Denmark	—	8.4	23.0	—	31.4	—	31.4
Finland	—	3.6	4.3	—	7.9	—	7.9
France	77.4	249.3	108.5	—	435.2	9.7	425.5
Germany	—	108.7	275.7	—	384.4	29.0	355.4
Ireland	—	13.4	28.9	—	42.3	3.7	38.6
Italy	—	13.8	—	—	13.8	—	13.8
Japan	—	16.3	—	—	16.3	—	16.3
Luxembourg	—	5.2	—	—	5.2	—	5.2
Mexico	—	7.5	—	—	7.5	—	7.5
Netherlands	4.4	183.9	111.1	—	299.4	—	299.4
New Zealand	—	18.0	8.5	—	26.5	—	26.5
Norway	43.0	—	18.1	—	61.1	—	61.1
Spain	—	8.7	16.0	—	24.7	—	24.7
Sweden	9.2	25.6	123.7	—	158.5	—	158.5
Switzerland	—	7.1	36.8	—	43.9	—	43.9
UK	2,780.9	1,144.3	921.1	4.7	4,851.0	241.1	4,609.9
United Arab Emirates	—	2.6	0.4	—	3.0	—	3.0
USA	—	128.3	185.0	—	313.3	—	313.3
Multilateral/Supranational	488.6	—	—	—	488.6	—	488.6
Total	3,481.3	2,041.4	2,042.2	43.0	7,607.9	283.5	7,324.4

The distribution of the debt securities held by geographical area in 2010, were as follows:

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	AFS—Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
Australia	—	32.0	267.5	35.3	334.8	—	334.8
Austria	2.8	—	9.8	—	12.6	—	12.6
Belgium	7.0	0.9	4.6	—	12.5	—	12.5
Canada	21.5	15.9	57.0	—	94.4	—	94.4
Denmark	—	—	84.9	—	84.9	—	84.9
Finland	—	—	4.4	—	4.4	—	4.4
France	—	133.4	170.3	—	303.7	10.1	293.6
Germany	—	98.1	245.1	9.3	352.5	40.2	312.3
Ireland	4.3	119.5	26.9	—	150.7	3.6	147.1
Italy	8.7	14.5	9.6	—	32.8	—	32.8
Japan	—	2.2	—	—	2.2	—	2.2
Luxembourg	—	5.1	—	—	5.1	—	5.1
Netherlands	4.5	136.6	136.4	—	277.5	—	277.5
New Zealand	—	17.7	14.4	—	32.1	—	32.1
Norway	—	—	0.8	—	0.8	—	0.8
Spain	—	—	120.3		120.3	—	120.3
Sweden	—	14.5	107.4	—	121.9	—	121.9
Switzerland	—	7.3	33.1	—	40.4	—	40.4
UK	2,728.7	590.0	1,574.4	—	4,893.1	442.2	4,450.9
United Arab Emirates	—	—	0.8	—	0.8	—	0.8
USA	—	65.4	299.4	—	364.8	—	364.8
Multilateral/Supranational	253.9	—	—	—	253.9	—	253.9
Total	3,031.4	1,253.1	3,167.1	44.6	7,496.2	496.1	7,000.1

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

The distribution of the debt securities held by geographical area in 2009, were as follows:

	AFS—Sovereign and Local Govt debt securities	AFS—Corporate debt securities	AFS—Banks—debt securities	Other Financial Institutions—debt securities	Total AFS debt securities	AFS—Mortgage Backed Securities	AFS—Non MBS—debt securities
Australia	—	22.1	329.3	23.5	374.9	—	374.9
Austria	—	—	9.7	—	9.7	—	9.7
Belgium	2.8	11.1	13.9	—	27.8	9.2	18.6
Canada	21.2	16.2	88.1	—	125.5	—	125.5
Cayman Islands	—	—	7.1	—	7.1	—	7.1
Denmark	—	—	63.5	—	63.5	—	63.5
Finland	—	—	—	—	—	—	—
France	9.0	27.5	236.9	—	273.4	8.8	264.6
Germany	—	41.8	287.9	—	329.7	32.4	297.3
Ireland	4.6	120.5	66.9	—	192.0	3.6	188.4
Italy	4.6	2.6	60.5	—	67.7	—	67.7
Japan	—	—	—	—	—	—	—
Luxembourg	—	5.1	—	—	5.1	—	5.1
Netherlands	4.5	116.0	172.0	—	292.5	—	292.5
New Zealand	—	8.4	24.6	—	33.0	—	33.0
Norway	32.6	—	6.0	—	38.6	—	38.6
Spain	29.4	—	260.3	—	289.7	—	289.7
Sweden	—	10.4	83.9	—	94.3	4.5	89.8
Switzerland	—	—	27.7	—	27.7	—	27.7
UK	1,212.8	611.6	2,074.6	—	3,899.0	627.8	3,271.2
United Arab Emirates	—	—	1.5	—	1.5	—	1.5
USA	—	77.6	384.6	—	462.2	—	462.2
Multilateral/Supranational	364.4	—	—	—	364.4	—	364.4
Total	1,685.9	1,070.9	4,199.0	23.5	6,979.3	686.3	6,293.0

The distribution of the debt securities held across industry sectors using Bloomberg classifications were as follows:

	2011		2010		2009	
	£ Million		£ Million		£ Million	
Asset Backed Securities	—	0%	—	0%	42.6	1%
Basic Materials	117.9	2%	70.0	1%	49.3	1%
Communications	196.7	3%	57.0	1%	22.1	0%
Consumer, Cyclical	56.1	1%	33.2	0%	26.8	0%
Consumer, Non-cyclical	291.4	4%	135.9	2%	75.8	1%
Diversified	148.5	2%	63.9	1%	41.3	1%
Energy	210.2	3%	116.7	2%	164.1	2%
Financial	1,917.4	25%	2,841.4	38%	3,692.8	53%
Government	3,481.2	44%	3,031.5	40%	1,686.0	24%
Industrial	100.9	1%	34.4	0%	1.4	0%
Mortgage	283.5	4%	496.1	7%	686.3	10%
Technology	—	0%	—	0%	4.4	0%
Utilities	804.1	11%	616.1	8%	486.4	7%
Total	7,607.9	100%	7,496.2	100%	6,979.3	100%

An investment in other investment funds which have a value of £382.8 million as at 31 December 2011 (2010: £370.9 million; 2009: £367.3 million) is not included in the above, as the disclosure of the funds held by industry sector is considered to be impractical.

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

3.7 Operational risk

Effective operational risk management requires the Group to identify, assess, manage, monitor, report and mitigate operational risk. Operational risk is inherent in all of the Group's business processes, systems and products, and from external events, with the Group's risk management framework detailing the minimum standards, tools, techniques and other processes used to ensure that operational risks are identified and managed to an acceptable level and that contingency plans are in place.

There are a number of key factors that cause operational risk across the Group:

- the Group's operations support complex transactions and are highly dependent on the proper functioning of IT and communication systems;
- a dependency on the use of third party information technology, software, data and service providers;
- a need to adequately maintain and protect customer and employee information;
- a reliance on certain services provided by RBS Group, including certain IT, business continuity, HR functions, finance functions, legal and company secretarial, property services and web services; and
- the ability of the Group to attract and retain key qualified personnel.

Effective operational risk management helps the Group to achieve its objectives, including:

- more focus on doing things the right way, leading to fewer surprises;
- fewer operational errors and losses, leading to increased customer satisfaction and higher quality earnings;
- better informed risk-taking, which creates greater rewards;
- increased management attention on the risks and issues that really matter; and
- lower risk based capital due to lower expected losses.

3.8 Emerging risk

There are a range of regulatory and legal changes which may impact the Group's reserves, pricing or financial performance in future years in relation to business already written. These include:

- on 14 December 2011, the Office of Fair Trading launched a market study into private motor insurance, with a focus on the provision of third party vehicle repairs and credit hire replacement vehicles to claimants;
- a ruling from the Court of Justice of the European Union in March 2011 prohibiting new contracts issued after 20 December 2012 from using gender-based factors in the calculation of individuals' premiums and benefits; and
- the European Union is in the process of developing and implementing a new regime in relation to solvency requirements and other matters affecting the financial strength of insurers ("Solvency 2") within each member state.

3.9 Capital risk

The Group defines capital in accordance with regulations prescribed by the FSA and other regulatory bodies and manages it in accordance with the Group's capital management policy. Its objectives when managing capital are:

- to comply with legal and statutory obligations and maintain capital resources commensurate with the nature, scale and risk profile of its business;

3. MANAGEMENT OF INSURANCE, FINANCIAL AND OPERATIONAL RISK (Continued)

- to provide a framework for monitoring the financial and capital position of the Group, including the procedures to be followed during periods of general financial distress, either due to internal or external events; and
- to safeguard the Group's ability to continue as a going concern.

Under the rules prescribed by the FSA, the Group must at all times maintain assets of a value sufficient to cover its liabilities, including liabilities arising under or in connection with contracts of insurance and that there is a suitable matching of assets and liabilities.

The FSA rules require the UK underwriting subsidiaries to maintain a surplus of admissible assets over their liabilities which is at all times at least equal to the higher of their EU minimum or their Individual Capital Guidance ("ICG"). Additionally, the Group must maintain a surplus of admissible assets over liabilities which is at all times at least equal its capital requirement under the Insurance Groups Directive ("IGD").

The MCR is calculated using the method prescribed by the EU, based on premium income and claims reserves; whereas the ICG is specified by the FSA following the submission of a risk based capital assessment (in accordance with the Individual Capital Adequacy Standards) by the UK Group to the FSA.

The international businesses are assessed under European Solvency I rules.

As at 31 December 2011, the Group held a surplus of at least £2,363.6 million (2010: £1,563.9 million; 2009: £1,952.2 million) above its IGD requirement of £1,079.1 million (2010: £1,227.3 million; 2009: £1,049.5 million).

Management information to monitor the Group's capital requirements and solvency position is produced and presented to the Group's Capital Management Committee on a regular basis.

4. SEGMENTAL ANALYSIS

The Group is a general insurer with leading direct market positions in the UK, Italy and Germany. The Group utilises a multi-brand, multi-product, multi-distribution channel business model that covers most major customer segments in the UK for personal lines general insurance and a more limited presence in the commercial market.

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 management team is accountable to the Group 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 partnerships or aggregators. 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 cover. The Group sells home insurance through its own brands—Direct Line, Churchill, and Privilege—and through partnerships or aggregators. The Group's brand and product offering covers most 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 business (closed for new business), creditor, income insurance and private insurance).

4. SEGMENTAL ANALYSIS (Continued)

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. 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 and Small Medium Enterprise businesses in the UK. The Group sells commercial products through its own brands—NIG and Direct Line for Business—and through its partnership with RBS and Natwest.

International

This segment consists primarily of motor insurance, sold to private customers in Germany and Italy using a multi-channel strategy through the Direct Line brand and through partnerships and aggregators.

Notes to the segmental analysis

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

Run-off

The businesses included in the run-off column consists of two principal business lines business, being policies written through partnership arrangements with Tesco Personal Finance ("TPF") and NIG personal lines business sold via brokers, both of which are now in run-off. TPF was entered into as a 50:50 joint venture with Tesco in 1999, whereby the Group underwrote a range of general and life insurance products under the Tesco brand to Tesco customers. The personal lines products were sold via brokers and the TPF business.

Restructuring and other one-off costs

Costs included within restructuring and other one-off costs include items that are exceptional in nature, including additional expenses as a result of separation from RBS Group and impairment of goodwill.

No inter segment transactions occurred in 2011, 2010 and 2009. If any transaction were to occur, transfer prices between operating segments are set on an arm's length basis in a manner similar to transactions with third parties. Segment income, expenses and results will include those transfers between business segments which will then be eliminated on consolidation.

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

4. SEGMENTAL ANALYSIS (Continued)

The following is an analysis of the Group's revenue and results by reportable segment for year ended 31 December 2011:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Total Ongoing £ Million	Run-off £ Million	Restructuring and other one-off costs £ Million	Total Group £ Million
Gross written premium	1,734.8	1,031.3	350.2	438.6	570.0	4,124.9	43.4	—	4,168.3
Gross earned premium	1,797.4	1,031.1	410.3	420.5	482.8	4,142.1	380.8	—	4,522.9
Reinsurance premium ceded	(25.8)	(57.0)	(19.5)	(27.8)	(121.1)	(251.2)	(18.7)	—	(269.9)
Net earned premium	**1,771.6**	**974.1**	**390.8**	**392.7**	**361.7**	**3,890.9**	**362.1**	**—**	**4,253.0**
Investment return	145.2	28.5	9.5	30.5	25.0	238.7	43.2	—	281.9
Instalment income and other operating income	208.2	35.1	—	5.0	7.2	255.5	(15.4)	—	240.1
Total income	**2,125.0**	**1,037.7**	**400.3**	**428.2**	**393.9**	**4,385.1**	**389.9**	**—**	**4,775.0**
Insurance claims	(1,501.6)	(579.2)	(195.7)	(268.6)	(391.4)	(2,936.5)	(224.1)	—	(3,160.6)
Insurance claims recoverable from reinsurers	54.8	19.9	22.1	11.9	96.8	205.5	(12.4)	—	193.1
Net insurance claims	**(1,446.8)**	**(559.3)**	**(173.6)**	**(256.7)**	**(294.6)**	**(2,731.0)**	**(236.5)**	**—**	**(2,967.5)**
Commission expenses	(25.9)	(170.0)	(87.8)	(82.3)	(28.6)	(394.6)	(124.3)	—	(518.9)
Other operating expenses	(397.5)	(196.5)	(75.6)	(101.6)	(66.4)	(837.6)	(53.0)	(54.0)	(944.6)
Total expenses	**(423.4)**	**(366.5)**	**(163.4)**	**(183.9)**	**(95.0)**	**(1,232.2)**	**(177.3)**	**(54.0)**	**(1,463.5)**
Operating profit / (loss)	**254.8**	**111.9**	**63.3**	**(12.4)**	**4.3**	**421.9**	**(23.9)**	**(54.0)**	**344.0**
Finance costs									(2.7)
Gain recognised on disposal of subsidiary and joint venture									1.6
Profit before tax									**342.9**
Loss ratio	81.7%	57.4%	44.4%	65.4%	81.4%	70.2%			
Commission ratio	1.5%	17.5%	22.5%	21.0%	7.9%	10.1%			
Expense ratio	22.4%	20.2%	19.4%	25.9%	18.3%	21.5%			
Combined operating ratio	105.6%	95.1%	86.3%	112.3%	107.6%	101.8%			

All operations are in the UK except for International which operates in Germany and Italy; and run-off, which includes the operations of the Group's Spanish joint venture, until its disposal in April 2009.

4. SEGMENTAL ANALYSIS (Continued)

The following is an analysis of the Group's revenue and results by reportable segment for year ended 31 December 2010:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Total Ongoing £ Million	Run-off £ Million	Restructuring and other one-off costs £ Million	Total Group £ Million
Gross written premium	1,902.2	1,034.4	335.5	397.7	425.5	4,095.3	875.7	—	4,971.0
Gross earned premium	1,932.4	1,018.7	413.9	393.1	361.1	4,119.2	1,033.2	—	5,152.4
Reinsurance premium ceded	(9.9)	(48.6)	(20.9)	(21.0)	(42.0)	(142.4)	(36.5)	—	(178.9)
Net earned premium	**1,922.5**	**970.1**	**393.0**	**372.1**	**319.1**	**3,976.8**	**996.7**	**—**	**4,973.5**
Investment return	176.3	39.8	20.2	20.4	24.7	281.4	40.3	—	321.7
Instalment income and other operating income	255.7	36.1	11.8	18.9	6.6	329.1	(33.9)	—	295.2
Total income	**2,354.5**	**1,046.0**	**425.0**	**411.4**	**350.4**	**4,587.3**	**1,003.1**	**—**	**5,590.4**
Insurance claims	(2,404.8)	(585.0)	(236.1)	(282.3)	(289.9)	(3,798.1)	(1,086.6)	—	(4,884.7)
Insurance claims recoverable from reinsurers	96.4	41.7	32.9	20.9	17.9	209.8	46.9	—	256.7
Net insurance claims	**(2,308.4)**	**(543.3)**	**(203.2)**	**(261.4)**	**(272.0)**	**(3,588.3)**	**(1,039.7)**	**—**	**(4,628.0)**
Commission expenses	(37.3)	(156.1)	(68.5)	(81.7)	(9.3)	(352.9)	(25.8)	—	(378.7)
Other operating expenses	(425.7)	(183.5)	(70.3)	(109.1)	(63.2)	(851.8)	(78.3)	(29.0)	(959.1)
Total expenses	**(463.0)**	**(339.6)**	**(138.8)**	**(190.8)**	**(72.5)**	**(1,204.7)**	**(104.1)**	**(29.0)**	**(1,337.8)**
Operating profit / (loss)	**(416.9)**	**163.1**	**83.0**	**(40.8)**	**5.9**	**(205.7)**	**(140.7)**	**(29.0)**	**(375.4)**
Finance costs									(2.7)
Loss before tax									**(378.1)**
Loss ratio	120.1%	56.0%	51.7%	70.3%	85.2%	90.2%			
Commission ratio	1.9%	16.1%	17.4%	22.0%	2.9%	8.9%			
Expense ratio	22.1%	18.9%	17.9%	29.3%	19.8%	21.4%			
Combined operating ratio	144.1%	91.0%	87.0%	121.6%	107.9%	120.5%			

4. SEGMENTAL ANALYSIS (Continued)

The following is an analysis of the Group's revenue and results by reportable segment for year ended 31 December 2009:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Total Ongoing £ Million	Run-off £ Million	Restructuring and other one-off costs £ Million	Total Group £ Million
Gross written premium	2,067.2	1,030.9	320.9	398.9	353.7	4,171.6	1,119.5	—	5,291.1
Gross earned premium	2,012.2	1,009.0	436.6	401.1	340.2	4,199.1	1,131.3	—	5,330.4
Reinsurance premium ceded	(23.9)	(54.3)	(22.0)	(20.0)	(49.1)	(169.3)	(32.8)	—	(202.1)
Net earned premium	**1,988.3**	**954.7**	**414.6**	**381.1**	**291.1**	**4,029.8**	**1,098.5**	**—**	**5,128.3**
Investment return	166.6	51.4	28.0	35.4	24.9	306.3	59.3	—	365.6
Instalment income and other operating income	211.7	32.8	12.2	1.7	8.1	266.5	(32.0)	—	234.5
Total income	**2,366.6**	**1,038.9**	**454.8**	**418.2**	**324.1**	**4,602.6**	**1,125.8**	**—**	**5,728.4**
Insurance claims	(2,013.6)	(526.9)	(264.6)	(250.9)	(263.8)	(3,319.8)	(981.9)	—	(4,301.7)
Insurance claims recoverable from reinsurers	25.9	7.1	13.4	11.7	21.4	79.5	39.9	—	119.4
Net insurance claims	**(1,987.7)**	**(519.8)**	**(251.2)**	**(239.2)**	**(242.4)**	**(3,240.3)**	**(942.0)**	**—**	**(4,182.3)**
Commission expenses	(31.0)	(161.8)	(17.4)	(79.8)	(10.9)	(300.9)	(259.9)	—	(560.8)
Other operating expenses	(479.9)	(186.5)	(71.0)	(93.9)	(64.5)	(895.8)	(89.0)	(80.0)	(1,064.8)
Total expenses	**(510.9)**	**(348.3)**	**(88.4)**	**(173.7)**	**(75.4)**	**(1,196.7)**	**(348.9)**	**(80.0)**	**(1,625.6)**
Operating profit / (loss)	**(132.0)**	**170.8**	**115.2**	**5.3**	**6.3**	**165.6**	**(165.1)**	**(80.0)**	**(79.5)**
Finance costs									(4.4)
Gain recognised on disposal of subsidiary and joint venture									216.1
Profit before tax									**132.2**
Loss ratio	100.0%	54.4%	60.6%	62.8%	83.3%	80.4%			
Commission ratio	1.6%	16.9%	4.2%	20.9%	3.8%	7.5%			
Expense ratio	24.1%	19.5%	17.1%	24.6%	22.1%	22.2%			
Combined operating ratio	125.7%	90.8%	81.9%	108.3%	109.2%	110.1%			

4. SEGMENTAL ANALYSIS (Continued)

Segmental assets and liabilities

The identifiable segment assets and liabilities for the year ended 31 December 2011 are as follows:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Run-off £ Million	Total Group £ Million
Goodwill	126.4	45.8	28.7	10.1	—	—	211.0
Other segment assets	7,241.2	1,565.9	316.7	1,486.4	1,070.8	1,878.1	13,559.1
Segment liabilities	(5,204.5)	(1,138.5)	(244.0)	(1,057.1)	(871.3)	(1,383.4)	(9,898.8)
Reportable segment net assets	**2,163.1**	**473.2**	**101.4**	**439.4**	**199.5**	**494.7**	**3,871.3**

The identifiable segment assets and liabilities for the year ended 31 December 2010 are as follows:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Run-off £ Million	Total Group £ Million
Goodwill	136.6	45.8	28.7	10.1	—	—	221.2
Other segment assets	6,695.7	1,522.3	419.3	1,334.0	933.0	2,691.4	13,595.7
Segment liabilities	(4,981.6)	(1,143.3)	(326.7)	(980.0)	(742.8)	(2,160.4)	(10,334.8)
Reportable segment net assets	**1,850.7**	**424.8**	**121.3**	**364.1**	**190.2**	**531.0**	**3,482.1**

The identifiable segment assets and liabilities for the year ended 31 December 2009 are as follows:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	International £ Million	Run-off £ Million	Total Group £ Million
Goodwill	144.1	45.8	30.5	10.1	—	—	230.5
Other segment assets	5,885.1	1,569.2	615.5	1,281.9	905.5	2,698.1	12,955.3
Segment liabilities	(4,274.9)	(1,145.1)	(458.0)	(916.0)	(707.0)	(2,104.2)	(9,605.2)
Reportable segment net assets	**1,754.3**	**469.9**	**188.0**	**376.0**	**198.5**	**593.9**	**3,580.6**

All operations are in the UK except for International which operates in Germany and Italy; and run-off, which includes the operation of the Group's Spanish Joint Venture, until its disposal in April 2009.

The reportable segment net assets do not represent the Group's view of the capital requirements for its operating segments.

5. NET EARNED PREMIUM

	2011 £ Million	2010 £ Million	2009 £ Million
Premium income from insurance contracts issued:			
Premium receivables	4,168.3	4,971.0	5,291.1
Change in unearned premium reserve	354.6	181.4	39.3
	4,522.9	5,152.4	5,330.4
Premium revenue ceded to reinsurers on insurance contracts issued:			
Premium payables	(257.1)	(183.5)	(199.6)
Change in unearned premium reserve	(12.8)	4.6	(2.5)
	(269.9)	(178.9)	(202.1)
Net earned premium	**4,253.0**	**4,973.5**	**5,128.3**

6. INVESTMENT RETURN

	2011 £ Million	2010 £ Million	2009 £ Million
Investment income			
Interest income on debt securities	208.1	229.0	228.7
Dividend income from equities	—	—	3.9
Other investment fund income	8.5	10.2	13.8
Cash and cash equivalent interest income	20.4	22.8	60.8
Property	6.6	7.1	7.1
Total	**243.6**	**269.1**	**314.3**
Net realised gains			
Debt	54.3	68.2	22.0
Equity	—	—	48.4
Other	—	0.1	—
Impairments to available-for-sale financial assets	(2.0)	(21.4)	(8.3)
Net unrealised (losses)/gains			
Property (note 19)	(14.0)	5.7	(10.8)
	281.9	**321.7**	**365.6**

Impairments to available-for-sale financial assets during 2011 and 2010 relate to debt securities and in 2009 to equity securities.

7. OTHER OPERATING INCOME

	2011 £ Million	2010 £ Million	2009 £ Million
Instalment income	145.0	187.7	155.9
Referral fee income	27.9	39.4	31.0
Revenue from vehicle recovery and repair services	39.3	32.9	33.5
Fee income from insurance intermediary services	3.4	10.2	13.3
Other income	24.5	25.0	0.8
	95.1	**107.5**	**78.6**

8. INSURANCE CLAIMS

	2011		
	Gross £ Million	Reinsurance £ Million	Net £ Million
Current accident year claims paid	1,646.5	(113.2)	1,533.3
Prior accident years' claims paid	1,976.4	(37.4)	1,939.0
Movement in claims provision	(462.3)	(42.5)	(504.8)
	3,160.6	**(193.1)**	**2,967.5**

8. INSURANCE CLAIMS (Continued)

	2010		
	Gross £ Million	Reinsurance £ Million	Net £ Million
Current accident year claims paid	2,026.4	(37.5)	1,988.9
Prior accident years' claims paid	1,800.5	(28.3)	1,772.2
Movement in claims provision	1,057.8	(190.9)	866.9
	4,884.7	**(256.7)**	**4,628.0**

	2009		
	Gross £ Million	Reinsurance £ Million	Net £ Million
Current accident year claims paid	2,106.9	(34.5)	2,072.4
Prior accident years' claims paid	1,721.6	(52.3)	1,669.3
Movement in claims provision	473.2	(32.6)	440.6
	4,301.7	**(119.4)**	**4,182.3**

Loss adjustment expenses for the year of £296.4 million (2010: £237.9 million; 2009: £226.6 million) have been included in the accident year claims figures above.

A reduction in the liability adequacy provision of £21.7 million (2010: £3.6 million charge; 2009: £24.1 million charge) has been included in the movement in the current accident year claims provision.

9. COMMISSION EXPENSES

	2011 £ Million	2010 £ Million	2009 £ Million
Commission expenses	324.5	395.6	411.7
Expenses incurred/(recovered) under profit participations	194.4	(16.9)	149.1
	518.9	**378.7**	**560.8**

10. OTHER OPERATING EXPENSES

	2011 £ Million	2010 £ Million	2009 £ Million
Staff costs	321.6	312.6	289.3
Marketing	203.5	202.5	218.5
Management fees	282.0	326.6	336.6
Depreciation (note 18)	10.4	11.1	11.9
Amortisation and impairment of intangible assets (note 20)	29.8	21.0	21.8
Impairment of goodwill (note 20)	10.2	9.3	66.8
Other operating expenses	87.1	76.0	119.9
	944.6	**959.1**	**1,064.8**

10. OTHER OPERATING EXPENSES (Continued)

Included in other operating expenses are run-off, restructuring and other one off costs as follows:

	2011	2010	2009
Staff costs	33.0	31.2	21.8
Management fees	42.0	59.2	68.2
Depreciation	—	—	1.2
Impairment of goodwill	10.2	9.3	66.8
Other operating expenses	21.8	7.6	11.0
	107.0	**107.3**	**169.0**

Staff costs attributable to claims handling activities are allocated to claims and loss adjustment expenses.

Management fees are in respect of expenses recharged from RBS Group plc. Such fees are charged on an arms length basis.

Number of employees	2011 Number	2010 Number	2009 Number
Operations	13,255	14,021	15,494
Support	2,054	1,962	1,295
	15,309	**15,983**	**16,789**

Their aggregate remuneration comprised:

	2011 £ Million	2010 £ Million	2009 £ Million
Wages and salaries	425.3	415.2	418.9
Social security costs	47.6	44.6	45.4
Other pension costs	41.6	40.2	39.5
	514.5	**500.0**	**503.8**

11. FINANCE COSTS

	2011 £ Million	2010 £ Million	2009 £ Million
Interest expense:			
Payable to RBS Group plc	2.3	2.2	3.8
Other	0.4	0.5	0.6
	2.7	**2.7**	**4.4**

12. TAX CHARGE/(CREDIT)

	2011 £ Million	2010 £ Million	2009 £ Million
Current taxation:			
Charge/(credit) for the year	157.2	(104.7)	(6.0)
Under-provision in respect of prior year	10.8	4.0	5.7
	168.0	(100.7)	(0.3)
Deferred taxation (note 13):			
(Credit)/charge for the year	(56.1)	(0.5)	8.5
Over-provision in respect of prior year	(18.0)	(5.0)	(9.1)
	(74.1)	(5.5)	(0.6)
Current taxation	168.0	(100.7)	(0.3)
Deferred taxation (note 13)	(74.1)	(5.5)	(0.6)
Tax charge/(credit) for the year	**93.9**	**(106.2)**	**(0.9)**

The actual income tax charge differs from the expected income tax charge computed by applying the standard rate of UK corporation tax of 26.5% (2010 and 2009: 28.0%) as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Expected tax charge/(credit)	90.9	(105.9)	37.0
Effects of:			
Net movement in impairment of goodwill	2.9	1.6	19.1
Realised gains on disposal of subsidiary and joint venture	0.4	—	(60.5)
Disallowable expenses	7.1	4.6	10.9
Non-taxable items	—	(3.9)	(4.0)
Effect on deferred tax balances due to the change in income tax rate	(0.2)	(1.6)	—
Over provision in respect of prior year	(7.2)	(1.0)	(3.4)
Tax charge/(credit)	**93.9**	**(106.2)**	**(0.9)**
Effective income tax rate	**27.4%**	**28.1%**	**(0.7)%**

The aggregate current and deferred tax relating to items that are charged or credited to other comprehensive income is £36.8 million (2010: £27.4 million; 2009: £41.5 million).

	2011 £ Million	2010 £ Million	2009 £ Million
Per balance sheet:			
Current tax assets	—	25.9	50.8
Current tax liabilities	(218.0)	(2.6)	(0.3)

13. DEFERRED TAXATION

The following are the deferred tax (assets)/liabilities recognised by the Group, and the movements thereon, during the current and prior reporting periods.

	Other timing differences £ Million	Retirement benefit obligation £ Million	Depreciation in excess of capital allowances £ Million	Non distributable reserves £ Million	Total £ Million
At 1 January 2009	22.9	(2.2)	(1.4)	44.1	**63.4**
(Credit)/charge to income statement	(8.7)	0.9	(0.1)	7.3	**(0.6)**
Credit to equity directly	(0.6)	(2.5)	—	—	**(3.1)**
At 31 December 2009	**13.6**	**(3.8)**	**(1.5)**	**51.4**	**59.7**
(Credit)/charge to income statement	(10.0)	0.9	0.1	3.5	**(5.5)**
Charge to equity directly	2.2	2.9	—	—	**5.1**
At 31 December 2010	**5.8**	**—**	**(1.4)**	**54.9**	**59.3**
(Credit)/charge to income statement	(28.3)	0.6	0.5	(46.9)	(74.1)
At 31 December 2011	**(22.5)**	**0.6**	**(0.9)**	**8.0**	**(14.8)**

	2011 £ Million	2010 £ Million	2009 £ Million
Per balance sheet			
Deferred tax assets	(26.9)	(17.0)	(17.1)
Deferred tax liabilities	12.1	76.3	76.8
	(14.8)	**59.3**	**59.7**

14. EARNINGS/(LOSS) PER SHARE

	2011 £ Million	2010 £ Million	2009 £ Million
Earnings/(loss) attributable to ordinary shareholders of the parent	249.0	(271.9)	133.1

	2011 Million	2010 Million	2009 Million
Weighted average number of shares:			
Average shares in issue	1,500.0	1,500.0	1,500.0
For basic and diluted earnings per share	**1,500.0**	**1,500.0**	**1,500.0**

	2011 Pence	2010 Pence	2009 Pence
Basic and diluted earnings/(loss) per share	16.6	(18.1)	8.9

Basic and diluted earnings per share is calculated by dividing the profit/(loss) attributable to owners of the Company by the weighted average number of ordinary shares in issue during the year.

15. PROFIT/(LOSS) FOR THE YEAR

	2011 £ Million	2010 £ Million	2009 £ Million
Profit/(loss) for the year is stated after charging			
Net foreign exchange losses	2.3	2.4	15.8
Depreciation of property, plant and equipment (note 18)	10.4	11.1	11.9
Impairment of goodwill (note 20)	10.2	9.3	66.8
Amortisation of software development costs (note 20)	21.1	18.5	20.6

Auditor's remuneration

Fees for audit and non-audit services are included within other operating expenses.

Fees paid to the auditor with respect to the statutory audit of the Group amount to £1.3 million (2010: £1.4 million; 2009: £1.4 million).

Fees in respect of the audit of the FSA Returns amount to £0.2 million in 2011 (2010: £0.1 million; 2009: £0.1 million) and fees for other services amount to £1.3 million in 2011 (2010: £1.5 million; 2009: nil). Other services relate to a review of the implementation of new claims systems and the divestment of the Group from RBS Group.

Directors' emoluments

	2011 £ Million	2010 £ Million	2009 £ Million
Fees as directors	0.1	0.1	0.1
Other emoluments	3.0	1.4	1.3
Company pension contributions	0.2	0.1	0.2
	3.3	**1.6**	**1.6**

Included in the above are emoluments, excluding pension contributions, paid to the highest paid director amounting to £1,497,310 (2010: £919,275; 2009: £438,132). A contribution of nil (2010: £100,000; 2009: £76,584) was made to a final salary scheme on behalf of the highest paid director. Three directors (2010: 1; 2009: nil) had retirement benefits accruing under money purchase pension schemes in respect of qualifying service.

During the year no directors exercised options (2010 and 2009: none).

16. CLASSIFICATION OF FINANCIAL INSTRUMENTS

The following table analyses the Group's financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Assets and liabilities outside the scope of IAS 39 are

16. CLASSIFICATION OF FINANCIAL INSTRUMENTS (Continued)

shown separately. Other than those financial assets and liabilities stated at fair value below, the carrying value of all other financial assets and liabilities equals their fair value.

At 31 December 2011

	Assets/ liabilities at fair value £ Million	Available for sale £ Million	Loans and receivables £ Million	Other (amortised costs) £ Million	Non-financial assets £ Million	Total £ Million
Assets						
Goodwill and other intangible assets	—	—	—	—	365.8	365.8
Property, plant and equipment	—	—	—	—	46.9	46.9
Investment property	—	—	—	—	69.5	69.5
Reinsurance assets	—	—	—	—	741.6	741.6
Deferred acquisition costs	—	—	—	—	310.5	310.5
Prepayments, accrued income and other assets	—	—	—	—	92.2	92.2
Insurance and other receivables	—	—	1,252.9	—	—	1,252.9
Deferred tax assets	—	—	—	—	26.9	26.9
Derivative financial instruments	0.1	—	—	—	—	0.1
Retirement benefit asset	—	—	—	—	2.6	2.6
Financial investments	—	7,990.7	1,489.6	—	—	9,480.3
Cash and cash equivalents	—	—	1,379.8	—	—	1,379.8
Assets held for sale	—	1.0	—	—	—	1.0
	0.1	7,991.7	4,122.3	—	1,656.0	**13,770.1**
Liabilities						
Insurance liabilities	—	—	—	—	6,509.0	6,509.0
Unearned premium reserve	—	—	—	—	1,931.6	1,931.6
Borrowings	—	—	—	317.9	—	317.9
Trade and other payables including insurance payables	—	—	—	832.6	77.6	910.2
Deferred tax liabilities	—	—	—	—	12.1	12.1
Current tax liabilities	—	—	—	—	218.0	218.0
	—	—	—	1,150.5	8,748.3	**9,898.8**
Total Equity						3,871.3
						13,770.1

16. CLASSIFICATION OF FINANCIAL INSTRUMENTS (Continued)

At 31 December 2010

	Assets/ liabilities at fair value £ Million	Available for sale £ Million	Loans and receivables £ Million	Other (amortised costs) £ Million	Non-financial assets £ Million	Total £ Million
Assets						
Goodwill and other intangible assets	—	—	—	—	286.1	286.1
Property, plant and equipment	—	—	—	—	52.6	52.6
Investment property	—	—	—	—	83.5	83.5
Reinsurance assets	—	—	—	—	660.9	660.9
Deferred acquisition costs	—	—	—	—	299.5	299.5
Prepayments, accrued income and other assets	—	—	—	—	113.3	113.3
Insurance and other receivables	—	—	1,606.2	—	—	1,606.2
Current tax assets	—	—	—	—	25.9	25.9
Deferred tax assets	—	—	—	—	17.0	17.0
Financial investments	—	7,867.1	963.4	—	—	8,830.5
Cash and cash equivalents	—	—	1,841.4	—	—	1,841.4
	—	7,867.1	4,411.0	—	1,538.8	**13,816.9**
Liabilities						
Insurance liabilities	—	—	—	—	6,941.4	6,941.4
Unearned premium reserve	—	—	—	—	2,288.6	2,288.6
Borrowings	—	—	—	327.1	—	327.1
Derivative financial instruments	0.7	—	—	—	—	0.7
Retirement benefit obligations	—	—	—	—	0.1	0.1
Trade and other payables including insurance payables	—	—	—	598.5	99.5	698.0
Deferred tax liabilities	—	—	—	—	76.3	76.3
Current tax liabilities	—	—	—	—	2.6	2.6
	0.7	—	—	925.6	9,408.5	**10,334.8**
Total Equity						3,482.1
						13,816.9

16. CLASSIFICATION OF FINANCIAL INSTRUMENTS (Continued)

At 31 December 2009

	Assets/ liabilities at fair value £ Million	Available for sale £ Million	Loans and receivables £ Million	Other (amortised costs) £ Million	Non-financial assets £ Million	Total £ Million
Assets						
Goodwill and other intangible assets	—	—	—	—	290.3	290.3
Property, plant and equipment	—	—	—	—	59.2	59.2
Investment property	—	—	—	—	77.8	77.8
Reinsurance assets	—	—	—	—	517.6	517.6
Deferred acquisition costs	—	—	—	—	338.5	338.5
Prepayments, accrued income and other assets	—	—	—	—	92.2	92.2
Insurance and other receivables	—	—	1,732.8	—	—	1,732.8
Current tax assets	—	—	—	—	50.8	50.8
Deferred tax assets	—	—	—	—	17.1	17.1
Derivative financial instruments	1.3	—	—	—	—	1.3
Financial investments	—	7,346.6	1,401.3	—	—	8,747.9
Cash and cash equivalents	—	—	1,260.3	—	—	1,260.3
	1.3	7,346.6	4,394.4	—	1,443.5	**13,185.8**
Liabilities						
Insurance liabilities	—	—	—	—	5,928.5	5,928.5
Unearned premium reserve	—	—	—	—	2,499.8	2,499.8
Borrowings	—	—	—	285.2	—	285.2
Retirement benefit obligations	—	—	—	—	13.6	13.6
Trade and other payables including insurance payables	—	—	—	689.1	111.9	801.0
Deferred tax liabilities	—	—	—	—	76.8	76.8
Current tax liabilities	—	—	—	—	0.3	0.3
	—	—	—	974.3	8,630.9	**9,605.2**
Total Equity						3,580.6
						13,185.8

17. ASSETS CLASSIFIED AS HELD FOR SALE

	2011 £ Million	2010 £ Million	2009 £ Million
Freehold property held for sale	**1.0**	**—**	**—**

The company intends to dispose of freehold property it no longer utilises at Lumbry Park, Alton. As at 31 December 2011 the property is actively being marketed, with no further impairment losses recognised on reclassification of the property as held for sale.

18. PROPERTY, PLANT AND EQUIPMENT

	Property, Plant and Equipment £ Million
Cost	
At 1 January 2009	183.6
Additions	8.4
Disposals	(96.2)
Effect of foreign currency exchange adjustment	(3.6)
At 31 December 2009	92.2
Additions	5.2
Disposals	(5.3)
Effect of foreign currency exchange adjustment	(0.5)
At 31 December 2010	91.6
Additions	7.5
Disposals	(7.9)
Classified as held for sale	(1.5)
Effect of foreign currency exchange adjustment	(0.6)
At 31 December 2011	89.1

	Property, Plant and Equipment £ Million
Depreciation	
At 1 January 2009	97.0
Depreciation charge for the year	11.9
Disposals	(74.2)
Effect of foreign currency exchange adjustment	(1.7)
At 31 December 2009	33.0
Depreciation charge for the year	11.1
Disposals	(4.7)
Effect of foreign currency exchange adjustment	(0.4)
At 31 December 2010	39.0
Depreciation charge for the year	10.4
Disposals	(6.4)
Classified as held for sale	(0.5)
Effect of foreign currency exchange adjustment	(0.3)
At 31 December 2011	42.2
Net book amount	
At 31 December 2011	**46.9**
At 31 December 2010	**52.6**
At 31 December 2009	**59.2**

19. INVESTMENT PROPERTIES

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	83.5	77.8	88.6
(Decrease)/increase in fair value	(14.0)	5.7	(10.8)
At 31 December	**69.5**	**83.5**	**77.8**

Investment properties comprise freehold property occupied by subsidiaries of The Royal Bank of Scotland Group plc under operating leases on an arms length basis. Valuations were carried out at 31 December 2011 by an independent valuer.

20. GOODWILL AND OTHER INTANGIBLE ASSETS

	Goodwill £ Million	Other intangible assets £ Million	Total £ Million
Cost			
At 1 January 2009	347.2	472.0	819.2
Exchange differences	(0.1)	(3.0)	(3.1)
Additions	—	8.1	8.1
Impairment and write off of intangible assets	—	(2.4)	(2.4)
Disposal of joint venture	—	(15.9)	(15.9)
At 31 December 2009	347.1	458.8	805.9
Exchange differences	(0.9)	(0.6)	(1.5)
Additions	—	26.2	26.2
Impairment and write off of intangible assets	—	(57.6)	(57.6)
At 31 December 2010	346.2	426.8	773.0
Exchange differences	(1.0)	(0.8)	(1.8)
Additions	—	119.8	119.8
Impairment and write off of intangible assets	—	(8.8)	(8.8)
At 31 December 2011	345.2	537.0	882.2

20. GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

	Goodwill £ Million	Other intangible assets £ Million	Total £ Million
Amortisation/accumulated impairment losses			
At 1 January 2009	42.1	394.6	436.7
Charge for the year	—	20.6	20.6
Exchange differences	7.7	(2.1)	5.6
Impaired and write off of intangible assets	66.8	(1.2)	65.6
Disposal of joint venture	—	(12.9)	(12.9)
At 31 December 2009	116.6	399.0	515.6
Charge for the year	—	18.5	18.5
Exchange differences	(0.9)	(0.5)	(1.4)
Impaired and write off of intangible assets	9.3	(55.1)	(45.8)
At 31 December 2010	125.0	361.9	486.9
Charge for the year	—	21.1	21.1
Exchange differences	(1.0)	(0.7)	(1.7)
Impaired and write off of intangible assets	10.2	(0.1)	10.1
At 31 December 2011	134.2	382.2	516.4
Net book amount			
At 31 December 2011	**211.0**	**154.8**	**365.8**
At 31 December 2010	**221.2**	**64.9**	**286.1**
At 31 December 2009	**230.5**	**59.8**	**290.3**

Other intangible assets primarily comprises software development costs and additions within other intangible assets were comprised of software development costs of £119.8 million (2010: £26.2 million; 2009: £8.1 million).

Goodwill has arisen primarily on the acquisition of U K Insurance Limited (£141 million) and Churchill Insurance Company Limited (£70 million) which is allocated across motor, home, rescue, and other personal lines and commercial on a relative value basis.

The Group's goodwill is reviewed annually at 30 September for impairment by comparing the recoverable amount of each cash generating unit ("CGU") to which goodwill has been allocated with its carrying value.

The CGUs of the Group are as follows:

	Motor £ Million	Home £ Million	Rescue and other personal lines £ Million	Commercial £ Million	Direct Line Insurance S.p.A £ Million	Direct Line Life Insurance Company Limited	Tracker Network (UK) Limited	Total £ Million
As at 1 January 2009	126.4	45.8	28.7	10.1	23.6	1.8	60.9	297.3
Impairment of goodwill	—	—	—	—	(23.6)	—	(43.2)	(66.8)
As at 31 December 2009	126.4	45.8	28.7	10.1	—	1.8	17.7	230.5
Impairment of goodwill	—	—	—	—	—	(1.8)	(7.5)	(9.3)
As at 31 December 2010	126.4	45.8	28.7	10.1	—	—	10.2	221.2
Impairment of goodwill	—	—	—	—	—	—	(10.2)	(10.2)
As at 31 December 2011	**126.4**	**45.8**	**28.7**	**10.1**	**—**	**—**	**—**	**211.0**

The recoverable amount is the higher of the unit's 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.

20. GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

Impairment testing inherently involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are 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.

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

The recoverable amount of the Motor business, based on a 3% terminal growth rate and a 10% post tax discount rate, exceeded the carrying amount by £1,441.5 million. A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £468.1 million and £456.1 million respectively. In addition, a 1% change in the forecast post tax earnings would change the recoverable amount by approximately £36.0 million.

The recoverable amount of the Home business, based on a 3% terminal growth rate and a 10% post tax discount rate, exceeded the carrying amount by £745.0 million. A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £157.8 million and £153.6 million respectively. In addition, a 1% change in the forecast post tax earnings would change the recoverable amount by approximately £12.2 million.

The recoverable amount of the Rescue and other personal lines business, based on a 3% terminal growth rate and a 10% post tax discount rate, exceeded the carrying amount by £745.7 million. A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £111.8 million and £108.6 million respectively. In addition, a 1% change in the forecast post tax earnings would change the recoverable amount by approximately £8.5 million.

The recoverable amount of the Commercial business, based on a 3% terminal growth rate and a 10% post tax discount rate, exceeded the carrying amount by £104.2 million. A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £78.9 million and £75.9 million respectively. In addition, a 1% change in the forecast post tax earnings would change the recoverable amount by approximately £5.4 million.

Tracker Network UK limited ("Tracker") provides stolen vehicle recovery systems and vehicle asset management systems. Goodwill in respect of Tracker has been impaired in 2011 by £10.2 million (2010: £7.5 million; 2009: £43.2 million) as performance has not been in line with that anticipated at the date of purchase. The recoverable amount has been calculated in each period using a value in use methodology, with the key assumptions underlying the calculation being a terminal growth rate of 3% (2010 and 2009: 3%) and a post tax discount rate of 10% (2010 10%: 2009: 12%)

For all other CGUs, key assumptions used in impairment testing in 2010 and 2009 were;

- terminal growth rate: 3% (2010 and 2009); and
- post tax discount rate: 10% (2010); 12% (2009)

21. SUBSIDIARIES

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

U K Insurance Limited and RBS Insurance Services Limited are owned directly by Direct Line Insurance Group plc, and Direct Line S.p.A is owned indirectly through intermediary holding companies.

21. SUBSIDIARIES (Continued)

All subsidiaries are included in the Group's combined financial statements and have an accounting reference date of 31 December.

Name of subsidiary	Place of incorporation and operation	Proportion of ownership interest (ordinary shares)	Proportion of voting power held	Principal activity
Direct Line Insurance S.p.A	Italy	Ordinary	100%	General insurance
RBS 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.

For details of the ownership of Direct Line Versicherung AG please see note 1 and note 1.1 in accounting policies.

The Group realised a profit on sale on disposal of a subsidiary in the year ended 31 December 2011 of £1.6 million (2010: nil; 2009: £216.1 million).

The disposal in 2011 was in respect of Devitt Insurance Services Limited which was sold to CKH Limited for a consideration of £2.3 million. Cash and cash equivalents included in the disposal were £2.4 million along with other assets of £7.3 million and other liabilities of £9.0 million.

The disposal in 2009 was in respect of the Group's 50% shareholding in Linea Directa Aseguradora S.A which was sold to Bankinter S.A for a consideration of £380.9 million. Cash and cash equivalents included in the disposal were £50.0 million along with debt securities of £321.7 million, fixed assets of £19.7 million, other assets of £61.3 million, insurance liabilities of £263.2 million and other liabilities of £24.7 million.

22. REINSURANCE ASSETS

	2011 £ Million	2010 £ Million	2009 £ Million
Reinsurers' share of general insurance liabilities	712.8	611.8	457.2
General insurance impairment provision	(53.9)	(9.2)	(1.8)
Reinsurers' share of life insurance liabilities	82.7	58.3	62.2
Total assets arising from reinsurance contracts	**741.6**	**660.9**	**517.6**

	2011 £ Million	2010 £ Million	2009 £ Million
Analysis of movement in impairment provision			
At 1 January	(9.2)	(1.9)	(2.4)
Impairment loss recognised on reinsurance contracts	(44.8)	(8.0)	—
Impairment losses reversed	0.1	0.7	0.6
At 31 December	**(53.9)**	**(9.2)**	**(1.8)**

23. DEFERRED ACQUISITION COSTS

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	299.5	338.5	364.0
Net credit/(charge) to the income statement	11.0	(39.0)	(13.9)
Disposal of joint venture	—	—	(11.6)
At 31 December	**310.5**	**299.5**	**338.5**

24. FINANCIAL INVESTMENTS

	2011 £ Million	2010 £ Million	2009 £ Million
Available-for-sale investments			
Government bonds	3,481.2	3,031.5	1,686.0
Corporate bonds	3,843.2	3,968.6	4,607.0
Mortgage-backed securities	283.5	496.1	686.3
Available-for-sale investments	7,607.9	7,496.2	6,979.3

	2011 £ Million	2010 £ Million	2009 £ Million
Debt securities:			
Listed—fixed interest rate	6,747.8	6,451.4	5,219.2
Listed—floating interest rate	860.1	1,044.8	1,760.1
	7,607.9	7,496.2	6,979.3
Other investment funds:			
Other investment funds	382.8	370.9	367.3
	382.8	370.9	367.3
Total available-for-sale investments	**7,990.7**	**7,867.1**	**7,346.6**

	2011 £ Million	2010 £ Million	2009 £ Million
Loans and receivables			
Deposits with credit institutions with maturities in excess of three months			
—third parties	1,342.6	821.4	981.3
—related parties (note 38)	147.0	142.0	420.0
Total loans and receivable deposits	**1,489.6**	**963.4**	**1,401.3**
Total financial investments	**9,480.3**	**8,830.5**	**8,747.9**

Included within the debt securities balance above is £304.6 million (2010: £562.0 million; 2009: £824.0 million) placed with members of The Royal Bank of Scotland group.

Other investment funds are an investment fund which include Euro and US Dollar denominated bonds, hedged back to sterling.

The following table shows an analysis of financial instruments recorded at fair value, which equates to its carrying value, by level of the fair value hierarchy:

At 31 December 2011

	Level 1 (note i) £ Million	Level 2 (note ii) £ Million	Total £ Million
Financial assets			
Available-for-sale financial assets			
Debt securities	2,862.6	4,745.3	7,607.9
Other investment funds	—	382.8	382.8
	2,862.6	**5,128.1**	**7,990.7**

24. FINANCIAL INVESTMENTS (Continued)

At 31 December 2010

	Level 1 (note i) £ Million	Level 2 (note ii) £ Million	Total £ Million
Financial assets			
Available-for-sale financial assets			
Debt securities	2,793.4	4,702.8	7,496.2
Other investment funds	—	370.9	370.9
	2,793.4	**5,073.7**	**7,867.1**

At 31 December 2009

	Level 1 (note i) £ Million	Level 2 (note ii) £ Million	Total £ Million
Financial assets			
Available-for-sale financial assets			
Debt securities	1,270.2	5,709.1	6,979.3
Other investment funds	—	367.3	367.3
	1,270.2	**6,076.4**	**7,346.6**

Sensitivity of financial instruments measured at fair value to changes in key assumptions

i) 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.

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

The Group held no Level 3 securities at 31 December 2011, 2010 and 2009.

25. INSURANCE AND OTHER RECEIVABLES

	2011 £ Million	2010 £ Million	2009 £ Million
Receivables arising from insurance and reinsurance contracts:			
Due from policyholders	988.9	1,212.3	1,413.5
Less provision for impairment of receivables from policyholders	(8.8)	(15.6)	(7.9)
Due from agents, brokers and intermediaries	176.9	281.9	197.6
Less provision for impairment of receivables from agents, brokers and intermediaries	(0.4)	(0.9)	(3.0)
Due from reinsurers:			
—third-party reinsurers	46.0	49.0	52.8
Other loans and receivables:			
Accrued interest	3.3	3.3	7.5
Receivables from related parties (note 38)	7.7	7.6	13.9
Other debtors	39.3	68.6	58.4
Total receivables including insurance receivables	**1,252.9**	**1,606.2**	**1,732.8**

26. CASH AND CASH EQUIVALENTS

	2011 £ Million	2010 £ Million	2009 £ Million
Cash at bank and in hand:			
—third parties	153.5	102.9	94.2
—related party (note 38)	48.4	131.4	29.3
	201.9	234.3	123.5
Short-term deposits with credit institutions:			
—third parties*	1,029.5	1,526.5	978.1
—members of RBS Group plc (note 38)	148.4	80.6	158.7
	1,177.9	1,607.1	1,136.8
Total cash and cash equivalents	**1,379.8**	**1,841.4**	**1,260.3**

* Included in the above are investments held by the Group in Global Treasury Funds PLC, (as open-ended umbrella investment company with variable capital incorporated with limited liability in Ireland) as at 31 December 2011 of £612.0 million (31 December 2010: £602.6 million; 31 December 2009: £545.7 million). RBS Asset Management (Dublin) Limited is the appointed manager to the fund.

The effective interest rate on short-term deposits with credit institutions was 0.78% (2010: 0.61%; 2009: 1.2%) and has an average maturity of 85 days (2010: 78 days; 2009: 57 days).

For the purposes of the cash flow statement, cash and bank overdrafts are as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Cash and cash equivalents	1,379.8	1,841.4	1,260.3
Bank overdrafts (note 31)	(70.2)	(77.9)	(34.4)
	1,309.6	**1,763.5**	**1,225.9**

27. INVESTED CAPITAL

	2011 £ Million	2010 £ Million	2009 £ Million
Authorised:			
Equity shares			
Ordinary shares of £1 each	**1,500.0**	**1,500.0**	**1,500.0**
Issued and fully paid:			
Equity shares			
Ordinary shares of £1 each			
At 1 January and 31 December	**1,500.0**	**1,500.0**	**1,500.0**

28. OTHER RESERVES AND RETAINED EARNINGS

	2011 £ Million	2010 £ Million	2009 £ Million
Capital contribution reserve	100.0	100.0	100.0
Reserve for revaluation of available-for-sale investments	137.1	41.9	(20.8)
Non distributable reserve	30.3	197.6	183.6
Foreign exchange translation reserve	6.4	5.4	5.3
Demerger reserve	301.4	245.5	143.3
Other reserves at 31 December	**575.2**	**590.4**	**411.4**
Retained earnings at 31 December	**1,537.6**	**1,133.2**	**1,410.7**
Non-controlling interest			
Undated loan capital	**258.5**	**258.5**	**258.5**

The non-controlling interest of £258.5 million was provided by Tesco Personal Finance Limited (TPF) in 2006. This is shown in the Group's capital as a perpetual subordinated loan and qualifies as tier two capital. There is no interest on this instrument.

Movements in the capital contribution reserve were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Capital contribution reserve at 1 January and 31 December	**100.0**	**100.0**	**100.0**

28. OTHER RESERVES AND RETAINED EARNINGS (Continued)

Movements in the revaluation reserve for available-for-sale investments were as follows:

	Equity shares £ Million	Other investment funds £ Million	Debt securities £ Million	Total £ Million
At 1 January 2009	(43.7)	—	(120.4)	**(164.1)**
Revaluation during the period—gross	101.3	2.2	144.4	**247.9**
Revaluation during the period—tax	(28.9)	(0.6)	(33.9)	**(63.4)**
Recycled to profit or loss on disposal of subsidiaries	—	—	3.3	**3.3**
Realised gains—gross	(40.1)	—	(22.0)	**(62.1)**
Tax on realised gains	11.4	—	6.2	**17.6**
At 31 December 2009	—	1.6	(22.4)	**(20.8)**
Revaluation during the period—gross	—	3.3	130.3	**133.6**
Revaluation during the period—tax	—	(0.9)	(36.3)	**(37.2)**
Realised gains—gross	—	—	(46.8)	**(46.8)**
Tax on realised gains	—	—	13.1	**13.1**
At 31 December 2010	**—**	**4.0**	**37.9**	**41.9**
Revaluation during the period—gross	—	11.8	172.0	**183.8**
Revaluation during the period—tax	—	(3.1)	(47.3)	**(50.4)**
Realised gains—gross	—	—	(52.3)	**(52.3)**
Tax on realised gains	—	—	14.1	**14.1**
At 31 December 2011	**—**	**12.7**	**124.4**	**137.1**

Movements in the non distributable reserves were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	197.6	183.6	158.3
Transfer (to)/from retained earnings for movement in year	(167.3)	14.0	25.3
At 31 December	**30.3**	**197.6**	**183.6**

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

Movements in the foreign translation exchange reserve were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	5.4	5.3	24.7
Disposal of subsidiary	—	—	(20.8)
Movement foreign currency translation adjustment	1.0	0.1	1.4
At 31 December	**6.4**	**5.4**	**5.3**

28. OTHER RESERVES AND RETAINED EARNINGS (Continued)

Movements in the demerger reserve were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	245.5	143.3	—
Costs recharged from RBS Group	55.9	102.2	143.3
At 31 December	**301.4**	**245.5**	**143.3**

For an explanation of the nature of the demerger reserve, please refer to note 1.

29. INSURANCE LIABILITIES, UNEARNED PREMIUM RESERVE AND REINSURANCE ASSETS

	2011 £ Million	2010 £ Million	2009 £ Million
Insurance liabilities			
Life insurance business (note 30)	97.8	74.2	86.7
General insurance business	6,411.2	6,867.2	5,841.8
Total insurance liabilities excluding unearned premiums	**6,509.0**	**6,941.4**	**5,928.5**
Gross (general insurance business)			
Claims reported	4,036.9	4,220.4	4,032.9
Claims incurred but not reported	2,217.5	2,514.2	1,675.4
Loss adjustment expenses	153.2	107.2	104.5
Liability adequacy provision	3.6	25.4	29.0
Total insurance liabilities, gross excluding unearned premiums	6,411.2	6,867.2	5,841.8
Unearned premiums	1,931.6	2,288.6	2,499.8
Total insurance liabilities, gross	**8,342.8**	**9,155.8**	**8,341.6**
Recoverable from reinsurers (general insurance business)			
Claims reported	(318.1)	(310.0)	(326.6)
Claims incurred but not reported	(281.8)	(220.8)	(52.1)
Total recoverable from reinsurers, excluding unearned premiums	(599.9)	(530.8)	(378.7)
Unearned premiums	(59.0)	(71.8)	(76.7)
Total reinsurers' share of insurance liabilities	**(658.9)**	**(602.6)**	**(455.4)**
Net (general insurance business)			
Claims reported	3,718.8	3,910.4	3,706.3
Claims incurred but not reported	1,935.7	2,293.4	1,623.3
Loss adjustment expenses	153.2	107.2	104.5
Liability adequacy provision	3.6	25.4	29.0
Total insurance liabilities, net excluding unearned premiums	5,811.3	6,336.4	5,463.1
Unearned premiums	1,872.6	2,216.8	2,423.1
Total insurance liabilities, net	**7,683.9**	**8,553.2**	**7,886.2**

29. INSURANCE LIABILITIES, UNEARNED PREMIUM RESERVE AND REINSURANCE ASSETS (Continued)

General insurance claims—gross
Accident year

	2002 £ Million	2003 £ Million	2004 £ Million	2005 £ Million	2006 £ Million	2007 £ Million	2008 £ Million	2009 £ Million	2010 £ Million	2011 £ Million	Total £ Million
Estimate of ultimate claims costs:											
At end of accident year	3,012.0	3,648.5	3,679.1	4,007.5	4,091.6	4,390.5	3,878.1	4,148.0	4,261.9	3,080.5	**38,197.7**
One year later	90.7	(135.6)	(187.2)	(175.8)	(266.1)	(62.0)	23.2	120.0	(98.1)	—	**(690.9)**
Two years later	4.4	(105.5)	(89.8)	(141.7)	(42.0)	(1.1)	43.9	(42.5)	—	—	**(374.3)**
Three years later	(2.3)	(62.1)	(61.3)	(57.9)	(17.6)	49.4	(38.3)	—	—	—	**(190.1)**
Four years later	(17.1)	(42.9)	(41.9)	(59.5)	10.1	(7.0)	—	—	—	—	**(158.3)**
Five years later	(6.1)	(19.7)	(15.2)	15.3	(21.6)	—	—	—	—	—	**(47.3)**
Six years later	(24.4)	(25.3)	70.5	7.8	—	—	—	—	—	—	**28.6**
Seven years later	(10.0)	19.5	12.8	—	—	—	—	—	—	—	**22.3**
Eight years later	19.5	7.7	—	—	—	—	—	—	—	—	**27.2**
Nine years later	(6.8)	—	—	—	—	—	—	—	—	—	**(6.8)**
Current estimate of cumulative claims	3,059.9	3,284.6	3,367.0	3,595.7	3,754.4	4,369.8	3,906.9	4,225.5	4,163.8	3,080.5	**36,808.1**
Cumulative payments to date	(3,007.6)	(3,146.1)	(3,150.9)	(3,404.7)	(3,435.1)	(3,861.4)	(3,277.8)	(3,211.2)	(2,853.9)	(1,326.0)	**(30,674.7)**
Liability recognised in balance sheet	52.3	138.5	216.1	191.0	319.3	508.4	629.1	1,014.3	1,309.9	1,754.5	**6,133.4**
Liability in respect of prior years before 2002											121.0
Loss adjustment expenses											153.2
Total gross liability included in the balance sheet											**6,407.6**

General insurance claims—net of reinsurance
Accident year

	2002 £ Million	2003 £ Million	2004 £ Million	2005 £ Million	2006 £ Million	2007 £ Million	2008 £ Million	2009 £ Million	2010 £ Million	2011 £ Million	Total £ Million
Estimate of ultimate claims costs:											
At end of accident year	2,583.0	3,207.4	3,486.1	3,869.6	4,030.8	4,341.3	3,816.0	4,113.0	4,219.3	2,946.1	**36,612.6**
One year later	58.0	(103.3)	(169.2)	(159.3)	(249.7)	(81.7)	24.1	70.0	(109.7)	—	**(720.8)**
Two years later	(7.5)	(101.8)	(94.1)	(159.4)	(52.7)	(23.3)	8.2	(23.0)	—	—	**(453.6)**
Three years later	(26.7)	(71.0)	(68.3)	(62.0)	(28.2)	17.7	(24.5)	—	—	—	**(263.0)**
Four years later	(19.5)	(42.4)	(53.3)	(61.6)	9.9	(10.4)	—	—	—	—	**(177.3)**
Five years later	(24.3)	(36.0)	(13.5)	7.2	(43.5)	—	—	—	—	—	**(110.1)**
Six years later	(39.7)	(20.5)	60.7	(0.4)	—	—	—	—	—	—	**0.1**
Seven years later	(9.9)	5.5	(4.1)	—	—	—	—	—	—	—	**(8.5)**
Eight years later	10.0	6.2	—	—	—	—	—	—	—	—	**16.2**
Nine years later	(15.5)	—	—	—	—	—	—	—	—	—	**(15.5)**
Current estimate of cumulative claims	2,507.9	2,844.1	3,144.3	3,434.1	3,666.6	4,243.6	3,823.8	4,160.0	4,109.6	2,946.1	**34,880.1**
Cumulative payments to date	(2,484.2)	(2,771.0)	(2,998.3)	(3,279.0)	(3,388.0)	(3,801.6)	(3,247.8)	(3,181.1)	(2,837.4)	(1,298.4)	**(29,286.8)**
Liability recognised in balance sheet	23.7	73.1	146.0	155.1	278.6	442.0	576.0	978.9	1,272.2	1,647.7	**5,593.3**
Liability in respect of prior years before 2002											61.2
Loss adjustment expenses											153.2
Total net liability											**5,807.7**

29. INSURANCE LIABILITIES, UNEARNED PREMIUM RESERVE AND REINSURANCE ASSETS (Continued)

Movements in insurance liabilities and reinsurance assets

(i) Claims and loss adjustment expenses

	Gross £ Million	Reinsurance £ Million	Net £ Million
Notified claims	4,092.7	(314.4)	3,778.3
Incurred but not reported	1,426.8	(43.7)	1,383.1
At 1 January 2009	**5,519.5**	**(358.1)**	**5,161.4**
Cash paid for claims settled in the year	(3,810.0)	77.1	(3,732.9)
Increase/(decrease) in liabilities			
—arising from current-year claims	4,331.9	(44.3)	4,287.6
—arising from prior-year claims	(63.3)	(61.8)	(125.1)
Net exchange differences	(29.2)	1.5	(27.7)
Disposals	(136.1)	6.9	(129.2)
At 31 December 2009	**5,812.8**	**(378.7)**	**5,434.1**
Notified claims	4,137.4	(326.6)	3,810.8
Incurred but not reported	1,675.4	(52.1)	1,623.3
At 31 December 2009	**5,812.8**	**(378.7)**	**5,434.1**
Cash paid for claims settled in the year	(3,907.0)	153.4	(3,753.6)
Increase/(decrease) in liabilities			
—arising from current-year claims	4,453.4	(105.1)	4,348.3
—arising from prior-year claims	486.4	(201.4)	285.0
Net exchange differences	(3.8)	1.0	(2.8)
At 31 December 2010	**6,841.8**	**(530.8)**	**6,311.0**
Notified claims	4,327.6	(310.0)	4,017.6
Incurred but not reported	2,514.2	(220.8)	2,293.4
At 31 December 2010	**6,841.8**	**(530.8)**	**6,311.0**
Cash paid for claims settled in the year	(3,547.7)	81.7	(3,466.0)
Increase/(decrease) in liabilities			
—arising from current-year claims	3,345.3	(134.4)	3,210.9
—arising from prior-year claims	(209.9)	(17.2)	(227.1)
Net exchange differences	(21.9)	0.8	(21.1)
At 31 December 2011	**6,407.6**	**(599.9)**	**5,807.7**
Notified claims	4,190.1	(318.1)	3,872.0
Incurred but not reported	2,217.5	(281.8)	1,935.7
At 31 December 2011	**6,407.6**	**(599.9)**	**5,807.7**

29. INSURANCE LIABILITIES, UNEARNED PREMIUM RESERVE AND REINSURANCE ASSETS (Continued)

(ii) Provisions for unearned premiums

	Gross £ Million	Reinsurance £ Million	Net £ Million
Unearned premium reserve			
At 1 January 2009	**2,710.9**	**(79.2)**	**2,631.7**
Net decrease in the year	(39.3)	2.5	(36.8)
Exchange movement	(14.3)	—	(14.3)
Disposal of joint venture	(157.5)	—	(157.5)
At 31 December 2009	**2,499.8**	**(76.7)**	**2,423.1**
Net decrease in the year	(181.4)	(4.6)	(186.0)
Exchange movement	(19.9)	(0.4)	(20.3)
Reclassification	(9.9)	9.9	—
At 31 December 2010	**2,288.6**	**(71.8)**	**2,216.8**
Net decrease in the year	(354.6)	12.8	(341.8)
Exchange movement	(2.4)	—	(2.4)
At 31 December 2011	**1,931.6**	**(59.0)**	**1,872.6**

(iii) Provisions for liability adequacy provision

	£ Million
Liability adequacy provision	
At 1 January 2009	**4.9**
Increase in the year	24.1
At 31 December 2009	**29.0**
Decrease in the year	(3.6)
At 31 December 2010	**25.4**
Decrease in the year	(21.8)
At 31 December 2011	**3.6**

30. LIFE INSURANCE CONTRACTS AND REINSURANCE ASSETS

	2011 £ Million	2010 £ Million	2009 £ Million
Gross			
Long-term insurance contracts:			
—with fixed and guaranteed terms	93.0	68.4	82.2
—benefits outstanding	4.8	5.8	4.5
Total insurance liabilities, gross	**97.8**	**74.2**	**86.7**
Recoverable from reinsurers			
Long-term insurance contracts			
—with fixed and guaranteed terms	(78.6)	(53.3)	(58.3)
—benefits outstanding	(4.1)	(5.0)	(3.9)
Total reinsurers' share of insurance liabilities	**(82.7)**	**(58.3)**	**(62.2)**
Net			
Long-term insurance contracts			
—with fixed and guaranteed terms	14.4	15.1	23.9
—benefits outstanding	0.7	0.8	0.6
Total insurance liabilities, net	**15.1**	**15.9**	**24.5**

	2011 £ Million	2010 £ Million	2009 £ Million
Current	5.8	6.4	10.2
Non-current	9.3	9.5	14.3
	15.1	**15.9**	**24.5**

Movements in life insurance liabilities and reinsurance assets

	Gross £ Million	Reinsurance £ Million	Net £ Million
At 1 January 2009	**95.4**	**(58.3)**	**37.1**
Provisions in respect of new and existing business	51.2	(24.9)	26.3
Expected change in existing business provisions	(9.0)	13.3	4.3
Variance between actual and expected experience	(40.6)	11.6	(29.0)
Other movements	(14.8)	—	(14.8)
At 31 December 2009	**82.2**	**(58.3)**	**23.9**

	Gross £ Million	Reinsurance £ Million	Net £ Million
At 1 January 2010	**82.2**	**(58.3)**	**23.9**
Provisions in respect of new and existing business	49.7	(26.3)	23.4
Expected change in existing business provisions	(15.2)	16.9	1.7
Variance between actual and expected experience	(35.7)	14.4	(21.3)
Other movements	(12.6)	—	(12.6)
At 31 December 2010	**68.4**	**(53.3)**	**15.1**

30. LIFE INSURANCE CONTRACTS AND REINSURANCE ASSETS (Continued)

	Gross £ Million	Reinsurance £ Million	Net £ Million
At 1 January 2011	**68.4**	**(53.3)**	**15.1**
Provisions in respect of new and existing business	45.9	(25.4)	20.5
Expected change in existing business provisions	(21.7)	16.2	(5.5)
Variance between actual and expected experience	8.7	(16.1)	(7.4)
Other movements	(8.3)	—	(8.3)
At 31 December 2011	**93.0**	**(78.6)**	**14.4**

31. BORROWINGS

	2011 £ Million	2010 £ Million	2009 £ Million
Loans from related parties (note 38)	247.7	249.2	250.8
Bank overdrafts with related parties (note 38)	64.2	77.9	34.4
Bank overdrafts with third parties	6.0	—	—
	317.9	**327.1**	**285.2**
On demand or within one year	71.5	296.0	253.2
One to five years	205.0	—	—
Six to ten years	11.3	—	—
After ten years	30.1	31.1	32.0
	317.9	**327.1**	**285.2**

The carrying value of borrowings approximates to their fair value.

32. DERIVATIVE FINANCIAL INSTRUMENTS

The Group enters into derivative financial instruments (derivatives) to manage balance sheet foreign exchange risk as per note 3.6.1.

The table below analyses the Group's derivative position at the balance sheet date:

	2011		2010		2009	
	Notional amounts £ Million	Assets £ Million	Notional amounts £ Million	Liabilities £ Million	Notional amounts £ Million	Assets £ Million
Forward foreign exchange contracts	53.5	0.1	57.8	(0.7)	70.0	1.3

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

33. RETIREMENT BENEFITS OBLIGATIONS

Defined contribution scheme

RBS Insurance Services Limited ("RBSISL") operates the Direct Line Group Pension Scheme which was established in 1988. The contributions paid by RBSISL are charged to the income statement, as incurred.

The pension charge in respect of the defined contribution scheme for the year was £28.0 million (2010: £35.8 million; 2009: £36.9 million).

33. RETIREMENT BENEFITS OBLIGATIONS (Continued)

Defined benefit scheme

The Group's defined benefit pension scheme was closed in 2003 although RBSISL remains the sponsoring employer for obligations to current and deferred pensioners.

The assumptions in respect of the defined benefit scheme and the amounts accounted for under IAS 19 are set out below.

	2011 %	2010 %	2009 %
Rate of increase in pension payment	2.1	2.7	3.5
Rates of increase of deferred pensions	2.1	2.7	3.5
Discount rate	5.0	5.5	5.9
Inflation rate	3.0	3.3	3.5

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

The assets in the Scheme and the expected rates of return are included in the table below together with the present value of the obligations and deficit in the Scheme.

	Expected return 2011 %	Value at 2011 £ Million	Expected return 2010 %	Value at 2010 £ Million	Expected return 2009 %	Value at 2009 £ Million
Equities	7.7	34.5	7.7	35.7	8.0	32.9
Index linked bonds	3.1	7.2	4.2	6.0	4.5	4.6
Government bonds	3.1	7.2	4.2	6.0	4.5	4.6
Corporate bonds	4.7	7.2	5.5	6.0	5.9	4.4
Other	5.0	0.6	5.5	0.7	6.4	0.7
Total market value of assets		**56.7**		**54.4**		**47.2**
Present value of fund obligations		54.1		54.5		60.8
Surplus/(deficit) in the Scheme		2.6		(0.1)		(13.6)
Deferred tax asset at 25% (2010 and 2009: 28%)		**0.7**		**0.0**		**3.8**

The expected return on scheme assets reflects the average rate of earnings expected on the investments made to provide the pension benefit obligations that are secured by the pension scheme. The starting point for setting the expected return was the nominal gross redemption yield on UK gilt-edged securities at the balance sheet date. As at 31 December 2011 the relevant yield was 3.1% (2010: 4.2%; 2009: 4.5%) a year. This assumption was used for the expected return on government bonds. The expected return on corporate bonds was set equal to the discount rate which implies a risk premium over government bonds of 1.6% (2010: 1.3%; 2009: 1.4%) a year. For equities it has been assumed that they will outperform government bonds by 4.6% (2010: 3.5%; 2009: 3.5%) a year.

The deferred tax asset has been netted off against the net pension liability and has been accounted for as a liability (note 13).

33. RETIREMENT BENEFITS OBLIGATIONS (Continued)

Amounts credited/(charged) to the income statement

	2011 £ Million	2010 £ Million	2009 £ Million
Interest on obligation	(3.0)	(3.5)	(2.9)
Expected return on plan assets	3.7	3.4	2.8
	0.7	**(0.1)**	**(0.1)**

The credit/(charge) to the income statement has been included under other operating expenses.

Amounts charged/(credited) to the statement of comprehensive income

	2011 £ Million	2010 £ Million	2009 £ Million
Actual return on scheme assets	(1.1)	(6.4)	(8.2)
less: expected return on scheme assets	3.7	3.4	2.8
Experience loss/(gain) on scheme assets	**2.6**	**(3.0)**	**(5.4)**
Experience gain on scheme liabilities	(0.4)	(0.4)	(2.6)
Changes in assumptions underlying the present value of scheme liabilities	(1.6)	(7.5)	16.6
Actuarial gain/(loss)	**0.6**	**(10.9)**	**8.6**

Changes in the present value of the defined benefit obligation are as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Opening defined benefit obligation	54.5	60.8	45.3
Interest cost	3.0	3.5	2.9
Actuarial (losses)/gains	(2.1)	(7.8)	14.0
Benefits paid	(1.3)	(2.0)	(1.4)
Closing defined benefit obligation	**54.1**	**54.5**	**60.8**

Changes in the fair value of the plan assets are as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Opening fair value of plan assets	54.4	47.2	37.5
Expected return	3.7	3.3	2.8
Actuarial (losses)/gains	(2.6)	3.1	5.4
Contributions by RBSISL	2.5	2.8	2.9
Benefits paid	(1.3)	(2.0)	(1.4)
Closing fair value of plan assets	**56.7**	**54.4**	**47.2**
Net pension surplus/(deficit) before deferred tax:			
brought forward	(0.1)	(13.6)	(7.8)
carried forward	**2.6**	**(0.1)**	**(13.6)**

33. RETIREMENT BENEFITS OBLIGATIONS (Continued)

The history of the plan for the current and prior years is as follows:

	2011 £ Million	2010 £ Million	2009 £ Million	2008 £ Million	2007 £ Million
Present value of defined benefit obligation	(54.1)	(54.5)	(60.8)	(45.3)	(53.6)
Fair value of plan assets	56.7	54.4	47.2	37.5	43.3
Surplus/(deficit)	**2.6**	**(0.1)**	**(13.6)**	**(7.8)**	**(10.3)**
Experience adjustments on plan liabilities	(0.4)	(0.5)	(2.6)	(0.7)	1.0
Experience adjustments on plan assets	2.6	(3.1)	(5.4)	(10.7)	(0.3)

Sensitivity analysis

The results of sensitivity testing are set out below. The impact of a reasonably possible change in a single factor is shown, with other assumptions left unchanged.

Sensitivity factor

Discount rate	The impact of a change in the principal actuarial assumptions on the discount rate for the present value of pension scheme obligations. This sensitivity analysis has been selected to reflect the changes to cash flows as a result of changes to the discount rate. The methodology adopted would involve actuarial techniques.
Inflation rate	The impact of a change in the principal actuarial assumptions on the inflation rate for the present value of pension scheme obligations. This sensitivity analysis has been selected to reflect the changes to the general level of prices of goods and services over time. The methodology adopted would involve actuarial techniques.

Sensitivity at 31 December 2011

	Discount rate +0.25%	Discount rate −0.25%	Inflation rate +0.25%	Inflation rate −0.25%
Impact on profit before tax (£ Million)	—	—	—	—
Impact before tax on total equity (£ Million)	(2.6)	2.6	2.5	(2.4)

Sensitivity at 31 December 2010

	Discount rate +0.25%	Discount rate −0.25%	Inflation rate +0.25%	Inflation rate −0.25%
Impact on profit before tax (£ Million)	—	—	—	—
Impact before tax on total equity (£ Million)	(2.6)	2.6	2.6	(2.5)

Sensitivity at 31 December 2009

	Discount rate +0.25%	Discount rate −0.25%	Inflation rate +0.25%	Inflation rate −0.25%
Impact on profit before tax (£ Million)	—	—	—	—
Impact before tax on total equity (£ Million)	(3.1)	3.2	3.2	(3.0)

A funding valuation of the defined benefit scheme as at 1 October 2011 is currently in progress. The scheme trustees and the Group are in discussion on this valuation and the level of contributions to be paid by the Group and expect to reach agreement in due course. The Group currently makes contributions of £2.5 million per annum for the future accrual of benefits, and does not anticipate any material change to the level of funding.

34. TRADE AND OTHER PAYABLES INCLUDING INSURANCE PAYABLES

	2011 £ Million	2010 £ Million	2009 £ Million
Provisions:			
Regulatory levies			
At 1 January	99.5	111.9	102.7
Charged to the income statement:			
—additional provisions	39.0	72.9	102.7
Disposal of subsidiary	—	—	(4.7)
Used during year	(60.9)	(85.3)	(88.8)
At 31 December	**77.6**	**99.5**	**111.9**

Trade and other payables, including insurance payables:

	2011 £ Million	2010 £ Million	2009 £ Million
Due to agents, brokers and intermediaries	4.8	10.9	25.8
Due to reinsurers	66.1	69.4	86.6
Due to insurance companies	—	6.0	11.4
Due to insurance partners	5.4	5.4	32.5
Due to related parties (note 38)	158.7	44.7	27.9
Trade creditors and accruals	212.2	140.8	165.8
Other creditors	287.6	239.4	246.4
Other taxes	86.5	69.7	71.2
Deferred income	11.3	12.2	21.5
	832.6	**598.5**	**689.1**
Total trade and other payables and provisions	**910.2**	**698.0**	**801.0**

The Company and RBS Group have agreed that the Company will pay an amount to RBS Group as payment for the transfer of ownership and control of Direct Line Versicherung AG to the Company. In the preparation of these combined financial statements a liability for this payment has been recognised. This liability is being re-measured at each period end with changes recognised in the combined statement of changes in equity. Included within other creditors is an amount of £110.9 million (2010: £101.3 million; 2009: £108.4 million) in respect of an inter company creditor with RBS Group in respect of this.

35. COMMITMENTS, CONTINGENCIES AND GUARANTEES

The Group did not have any contingent liabilities.

A Group company has guaranteed the performance of certain contracts with partners. The guarantees total £70.5 million as at 31 December 2011.

36. NOTES TO THE COMBINED CASH FLOW STATEMENT

	2011 £ Million	2010 £ Million	2009 £ Million
Profit/(loss) for the year	249.0	(271.9)	133.1
Adjustments for:			
Investment revenues	(394.0)	(453.9)	(470.2)
Other (losses)/gains—derivatives	2.0	2.1	(8.8)
Net fair value gains/(losses) on assets at fair value through income	14.0	(5.7)	14.4
Other operating (loss)/income	(11.8)	(7.6)	3.5
Finance costs	2.7	2.5	4.4
Tax charge/(credit)	93.9	(106.2)	(0.9)
Depreciation of property, plant and equipment (note 10)	10.4	11.1	11.9
Amortisation of intangible assets	21.1	18.5	20.6
Non cash movement in demerger reserve	55.9	102.2	143.3
Derecognition of intangible assets	—	—	1.4
Impairment loss on property, plant and equipment	—	0.2	0.1
Impairment of goodwill and intangible assets	18.9	11.8	68.0
Impairment losses on equity shares	—	—	8.3
Impairment losses on debt securities	2.0	21.4	—
Impairment losses on reinsurance contracts	44.7	7.4	(0.6)
Loss on sale of available-for-sale equity investments	—	—	(48.3)
Profit on sale of available-for-sale debt securities	(52.9)	(37.1)	(25.6)
Loss on sale of property, plant and equipment	0.2	—	0.6
Profit on disposal of subsidiary and joint venture	(1.6)	—	(216.1)
Unrealised loss on foreign exchange translations on investments	—	2.3	8.7
Other income/(loss)	22.2	43.0	(1.8)
Operating cash flows before movements in working capital	**76.7**	**(659.9)**	**(354.0)**
Movements in working capital			
Net (increase)/decrease in insurance net assets	(727.2)	712.8	351.5
Net (increase)/decrease in reinsurance assets	(158.2)	(166.8)	10.4
Net decrease in inventories	—	1.6	0.4
Net decrease in prepayments and accrued income	0.1	1.6	0.4
Net decrease/(increase) in trade and other receivables	4.0	149.8	(4.4)
Net (increase)/decrease in derivative financial instruments	(0.4)	0.4	(0.2)
Net increase/(decrease) in trade and other payables	26.0	2.7	(11.5)
Net decrease in loans and receivables	233.9	51.2	1.0
Net decrease/(increase) in other assets	34.3	(37.5)	(12.7)
Net decrease/(increase) in related party balances	114.5	401.4	(156.2)
Net increase/(decrease) in other liabilities	132.3	(58.4)	17.1
Cash (used by)/generated from operations	**(264.0)**	**398.9**	**(158.2)**
Taxes received/(paid)	20.7	63.4	(209.4)
Interest paid	(2.5)	(2.5)	(2.9)
Net cash flow (used by)/generated from operating activities before investment of insurance assets	**(245.8)**	**459.8**	**(370.5)**
Interest received	440.8	467.7	506.0
Rental income received from investment properties	7.1	7.3	8.4
Dividends received from equity shares	—	—	13.8
Distributions received from other investment funds	8.5	10.2	3.9
Proceeds on disposal of available-for-sale equity investments	—	—	738.7
Proceeds on disposal/maturity of available-for-sale debt securities	6,403.4	3,448.3	1,579.9
Net (increase)/decrease in investment balances held with credit institutions	(422.9)	438.0	2,284.5
Purchases of equity investments	—	—	(27.5)
Purchases of debt securities	(6,398.1)	(3,885.5)	(3,867.0)
Purchases of other investment funds	—	—	(365.0)
Cash generated from investment of insurance assets	**38.8**	**486.0**	**875.7**

37. COMMITMENTS

Operating lease commitments

The Group leases vehicles under non-cancellable operating lease agreements.

The Group also leases vehicles and other assets under cancellable operating lease agreements.

	2011 £ Million	2010 £ Million	2009 £ Million
Minimum lease payments under operating leases recognised as an expense in the year	7.4	7.5	8.8

At the balance sheet date, the Group had outstanding commitments under non-cancellable operating leases, which fall due as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Within one year	8.7	9.2	9.8
In the second to fifth years inclusive	19.0	18.7	21.3
After five years	9.3	10.6	12.1
	37.0	**38.5**	**43.2**

38. RELATED PARTIES

On 1 December 2008, the UK Government through HM Treasury became the ultimate controlling party of The Royal Bank of Scotland Group plc. The UK Government's shareholding is managed by UK Financial Investments Limited, a company wholly owned by the UK Government. The nature of transactions consist of tax balances with Her Majesty's Revenue and Customs ("HMRC") and debt security investments with the UK Government.

The Group's ultimate and immediate holding company is The Royal Bank of Scotland Group plc which is incorporated in the United Kingdom and registered in Scotland.

As at 31 December 2011, The Royal Bank of Scotland Group plc heads the largest group in which the group is consolidated. Copies of the consolidated accounts of The Royal Bank of Scotland Group plc may be obtained from The Secretary, The Royal Bank of Scotland Group plc, Gogarburn, PO Box 1000, Edinburgh EH12 1HQ.

The following transactions were carried out with related parties, who are all members of The Royal Bank of Scotland Group.

i. Sales of insurance contracts and other services

	2011 £ Million	2010 £ Million	2009 £ Million
Sales of services:			
Fellow subsidiaries	17.6	14.6	45.9

ii. Purchases of services

	2011 £ Million	2010 £ Million	2009 £ Million
Parent	211.8	187.3	181.8
Fellow subsidiaries	63.9	87.7	41.4
	275.7	275.0	223.2

38. RELATED PARTIES (Continued)

Purchases of services are charged on an arm's length basis.

Employee costs recharged by RBS Group plc and include the full costs of key managers and other staff in respect of share-based payments. The attribution among members of the RBS Group has regard to the needs of the Group as a whole.

iii. Compensation of key management

The aggregate remuneration of directors and other members of key management during the year was as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
Fees as directors	0.1	0.1	0.1
Other emoluments	6.2	3.3	2.1
Company pension contributions	0.6	0.4	0.3
	6.9	3.8	2.5

iv. Year-end balances arising from cash and investment transactions with members of the Royal Bank of Scotland Group

	2011 £ Million	2010 £ Million	2009 £ Million
Cash at bank held with related parties (note 26)	48.4	131.4	29.3
Short-term bank deposits held with related parties (note 26)	148.4	80.6	158.7
Bank overdrafts held with related parties (note 31)	(64.2)	(77.9)	(34.4)
Term deposits held with related parties (note 24)	147.0	142.0	420.0
	279.6	276.1	573.6

Debt securities held with related parties (note 24)

	2011 £ Million	2010 £ Million	2009 £ Million
RBS Group plc issuers	304.6	562.0	824.0
	304.6	562.0	824.0

v. Year-end balances arising from sales/purchases of products/services.

Receivables from fellow subsidiaries of RBS Group plc (note 25)

	2011 £ Million	2010 £ Million	2009 £ Million
Parent	0.1	—	—
Fellow Subsidiaries	7.6	7.6	13.9
	7.7	7.6	13.9

38. RELATED PARTIES (Continued)

Movements in receivables from related parties were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	7.6	13.9	51.9
Transactions in the year	7.3	9.3	45.1
Settled in the year	(7.2)	(15.6)	(83.1)
At 31 December	7.7	7.6	13.9

Due to related parties (note 34)

	2011 £ Million	2010 £ Million	2009 £ Million
Parent	75.1	10.7	24.4
Fellow Subsidiaries	83.6	34.0	3.5
	158.7	44.7	27.9

Movements due to related parties were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	44.7	27.9	29.4
Transactions in the year	261.0	266.8	232.7
Settled in the year	(147.0)	(250.0)	(234.2)
At 31 December	158.7	44.7	27.9

Included in the above is an amount of £47.3 million invoiced by and paid to the Royal Bank of Scotland plc for the acquisition of software assets.

vi. Loans from related parties (note 31)

	2011 £ Million	2010 £ Million	2009 £ Million
Parent	12.5	13.0	13.9
Fellow Subsidiary	235.2	236.2	236.9
	247.7	249.2	250.8

Movements in loans from related parties were as follows:

	2011 £ Million	2010 £ Million	2009 £ Million
At 1 January	249.2	250.8	254.0
Loan repayments made	(0.5)	(0.9)	(0.8)
Interest charged (note 11)	2.3	2.2	3.8
Interest settled	(2.3)	(2.2)	(3.8)
Exchange movements	(1.0)	(0.7)	(2.4)
At 31 December	247.7	249.2	250.8

39. POST BALANCE SHEET EVENTS

On 27 March 2012, Direct Line Insurance Group plc paid a dividend to its parent company, the Royal Bank of Scotland Group plc, of £300.0 million.

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