Annual Report & Accounts 2017

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A year of strong progress

Paul Geddes, CEO of Direct Line Group, commented:

"2017 is the fifth successive year in which we have delivered a strong financial performance. We have seen significant growth in our direct own brand policies as more customers respond positively to the many improvements we have made to the business. This success has resulted in our proposing an increase in the final dividend by 40.2% to 13.6 pence, bringing the total ordinary dividend to 20.4 pence and declaring a special dividend of 15.0 pence. This amounts to a cash return of £486 million to shareholders.

"At half year we refreshed our medium-term targets and our results show we've been delivering on our management priorities to maintain revenue growth, reduce expense and commission ratios and deliver underwriting and pricing excellence.

"Looking to the future, this success enables us to continue investing in our technology and customer experience, supporting our plans to grow the business whilst improving efficiency. Together with our track record of delivery, these give us the confidence to continue to target a combined operating ratio of 93% to 95% over the medium term."

Watch CEO, Paul Geddes comment on the 2017 results
www.directlinegroup.co.uk/investors

Our strong performance reflects our success in satisfying customers and a focus on profitability and returns

- Strong growth in direct own brands[1] premiums and in-force policies up 9.3% and 5.3% respectively, driven again by continued Direct Line momentum in Motor
- Operating profit from Ongoing operations of £610.9 million (2016: £403.5 million), primarily due to the non-repeat of the Ogden discount rate change which was reflected in 2016's results. Profit before tax of £539.0 million (2016: £353.0 million)
- Reported expense ratio in line with 2016. Excluding non-cash intangible assets impairment of £56.9 million (2016: £39.3 million), underlying expense ratio improved 0.5 percentage points to 23.5%
- Combined operating ratio[2] from Ongoing operations of 91.8% (2016: 97.7%) reflecting strong Motor and Commercial performance, including from prior-year reserve releases. Adjusted for normal weather, combined operating ratio towards the lower end of the target range 93% to 95%
- Final regular dividend up by 40.2% to 13.6 pence bringing the total ordinary dividends to 20.4 pence (2016: 14.6 pence) and a special dividend of 15.0 pence (2016: 10.0 pence). Total dividends for 2017 of 35.4 pence per share (2016: 24.6 pence)

Profit before tax[1]

£539.0m
(2016: £353.0m)

Return on tangible equity[1]

21.7%
(2016: 14.2%)

Combined operating ratio[2]
Ongoing operations[1]

91.8%
(2016: 97.7%)

Gross written premium

£3,392.1m
(2016: £3,274.1m)

Expense ratio[2]
Ongoing operations[1]

25.3%
(2016: 25.3%)

Operating profit[1]
Ongoing operations[1]

£610.9m
(2016: £403.5m)

Solvency capital ratio[3]

162%
(2016: 165%)

Dividend per share

35.4p
(2016: 24.6p)

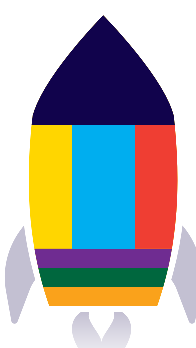
Commission ratio[2]

9.1%
(2016: 11.5%)

Notes:
1. See glossary on pages 174 to 176 for definitions and Appendix A Alternative performance measures ("APM") from page 177 for reconciliation to financial statement line items.
2. A reduction in the ratio represents an improvement as a proportion of net earned premium, while an increase in the ratio represents a deterioration. See glossary on page174 for definitions.
3. Estimates based on the Group's Solvency II partial internal model.

Creating shareholder value

Five years after the Group's initial public offering we have consistently achieved profitable growth and returned £2.4 billion to shareholders including the ordinary and special dividends for 2017 of £486 million. Our successful strategy, built around our "rocket" (see page 14), has enabled us to launch new medium-term financial targets:



Combined operating ratio
93%-95%

RoTE[1] at least
15%

Grow our dividend in line with business growth

Maintain solvency capital around the middle of the 140% to 180% Solvency II target range

Our three strategic pillars have already helped us deliver sustainable growth and at least 15% RoTE[1].

Great retailer

Our multiple leading brands offer differentiated propositions through a range of distribution channels, answering the needs of different customers. 2017 has continued a trend of growth in own brand in-force policy count. As a result of listening to our customers we challenged the trend of commoditisation, and invested in our Direct Line brand. We did this because we are convinced that great brands and propositions attract customers and build great relationships which deliver real shareholder value. Since its relaunch in 2014, Direct Line has grown consistently year on year.

Smart and efficient manufacturer

We have the scale and data to provide our customers with an excellent service at a competitive price however they choose to access our insurance – via partners, price comparison websites ("**PCWs**") or direct. As an example, a strategic decision was taken with the aim of becoming the largest insurance owner of accident repair centres in the UK. This helped us continue the brand experience throughout the customer journey, targeting excellent workmanship and service at highly competitive prices. We are well placed to work with our partners to deliver more than just insurance. We want to build sustainable relationships, combining our strengths to meet our customers' needs, such as working on digital innovations with our partner RBS[2], helping their customers receive fast, pre-populated insurance quotes.

Lead and disrupt

The way customers buy, the risks they face and the assets they use are changing at a rapid pace – our philosophy is to embrace those changes and help shape the future. Our digital capabilities mean we can open up new markets; Direct Line for Business has done this with small and medium-sized enterprises ("**SMEs**"). It also enables us to work with leading car manufacturers, such as Tesla, Peugeot and Citroën and Volkswagen Insurance Service (Great Britain) Limited so together we can learn from technology and develop the right solutions to support their customers.

Notes:
1. Return on tangible equity. See glossary on pages 174 to 176 for definition.
2. The Royal Bank of Scotland Group plc, including National Westminster Bank plc.

A proven track record

Our performance in the five years since our initial public offering demonstrates the strength of our strategy and processes.

Return on tangible equity
(%)

21.7%

Year	%
2017	**21.7**
2016	14.2
2015	18.5
2014	16.8
2013	16.0

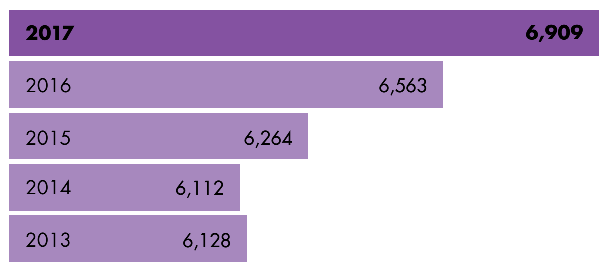
Dividend per share
(pence)

35.4p

Year	Pence
2017	**35.4**
2016	24.6
2015	50.1
2014	27.2
2013	20.6

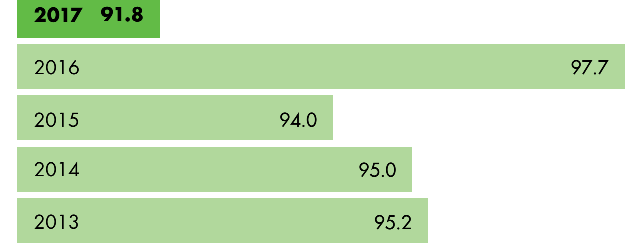
Own brand in-force policy count
(thousands)

6,909



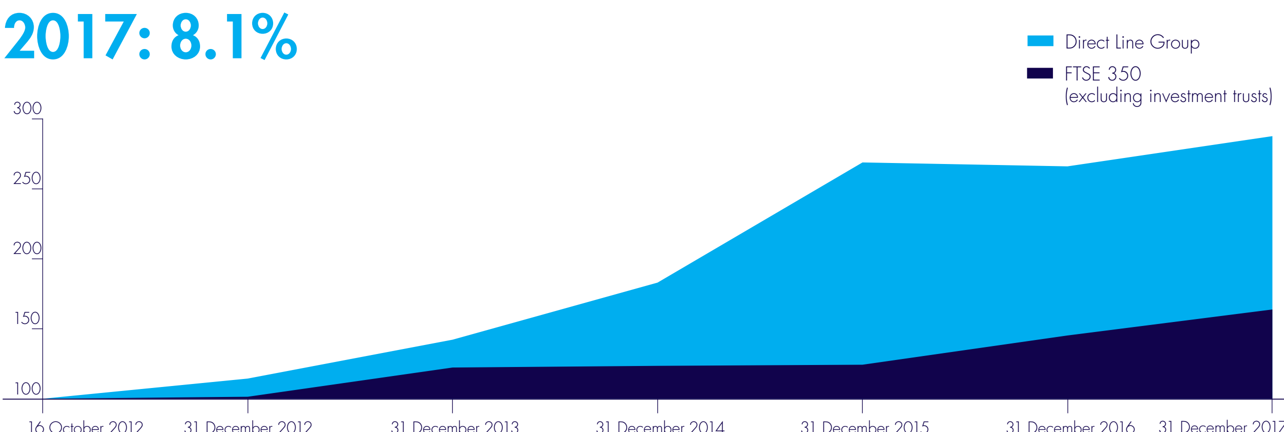
Combined operating ratio
(%)

91.8%



Total Shareholder Return
(%)

2017: 8.1%



A diverse proposition

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

Our brands

Direct Line has maintained its brand heritage of speed, simplicity and a common-sense human touch. We continue to sell products direct to customers by phone and online. Our customers want a premium product with exceptional customer care that is tailored to their needs at a competitive price.

www.directline.com

Churchill is one of Britain's most recognisable brands. Our products are available by phone and online, including PCWs. Our customers are looking for a dependable partner who is reliable, trustworthy, and happy to spend time making sure they are happy. Those values are at the heart of the brand.

www.churchill.com

Green Flag is our roadside rescue and recovery service. It is a standalone service and an optional product alongside motor insurance across all of our brands. Green Flag offers an award-winning breakdown service at a much cheaper price than its two biggest rivals.

www.greenflag.com

Direct Line for Business is an extension of our Direct Line brand. We market a range of business insurance products over the phone and online. Our customers are looking for the right level of cover at the right price.

www.directlineforbusiness.co.uk

Privilege targets customers who mainly buy through PCWs. Our customers want a quick and efficient service at the best price.

www.privilege.com

NIG is our commercial insurance brand dedicated to the broker market and is focused on a number of specialisms including SMEs, Agriculture and Real Estate. We sell our products through over 2,000 brokers, including an in-house intermediary that arranges commercial insurance for partnerships, such as RBS and NatWest.

www.nig.com

DLG Partnerships is the Group's partnerships arm. We specialise in providing personal lines insurance, and roadside rescue and recovery products to some well-known brands.

Motor

We are Britain's leading personal motor insurer measured by in-force policies[1], mainly represented through our well-known brands Direct Line, Churchill and Privilege, and also through our partners. We insure around one in six insured cars on the road in the UK, representing 4.0 million in-force policies.

Home

We are one of Britain's leading personal home insurers measured by in-force policies[1]. We reach our customers by selling home insurance products through our brands Direct Line, Churchill and Privilege, and our partners RBS, NatWest and Prudential.

Rescue and other personal lines

We are one of the leading providers of rescue and other personal lines insurance in the UK[2, 3] with 7.7 million in-force policies. This includes providing roadside assistance and recovery for customers through Green Flag, the UK's third largest roadside recovery provider[2]. We also offer customers protection for their holidays and pets and are the second largest travel and the fourth largest pet insurer respectively[3].

Commercial

We protect commercial businesses through our brands, NIG, Direct Line for Business and Churchill, and through our partners RBS and NatWest. NIG sells its products exclusively through brokers operating across the UK. Direct Line for Business provides business, van and landlord insurance products direct to customers. Churchill sells business, landlord and van products direct to customers and through PCWs.

Motor

£1,670.4m
Gross written premium

4.0m
In-force policies

91.9%
Combined operating ratio

£364.5m
Operating profit

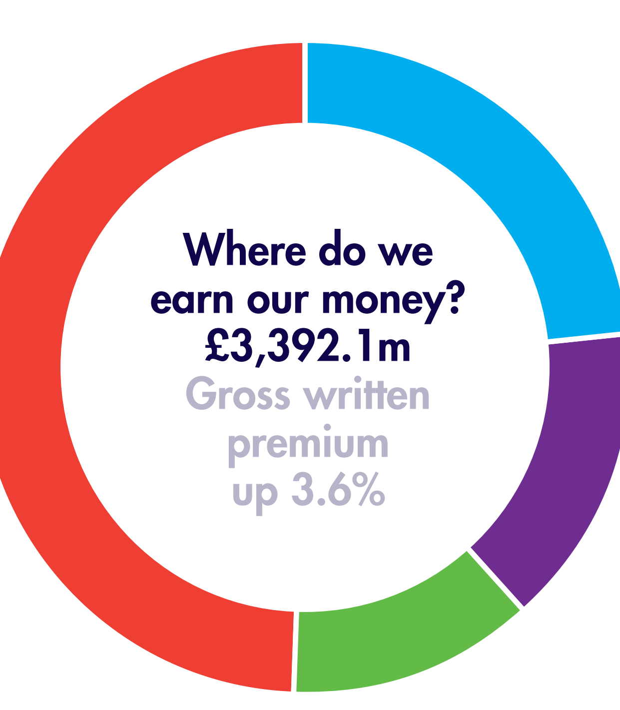
Rescue and other personal lines

£421.1m
Gross written premium

7.7m
In-force policies

94.3%
Combined operating ratio

£43.6m
Operating profit



Home

£799.1m
Gross written premium

3.2m
In-force policies

89.4%
Combined operating ratio

£128.8m
Operating profit

Commercial

£501.5m
Gross written premium

708k
In-force policies

93.4%
Combined operating ratio

£74.0m
Operating profit

Notes:
1. Includes Direct Line, Churchill, Privilege and partner brands: RBS, NatWest, Prudential and Sainsbury's © GfK Financial Research Survey six months ending January 2018, 14,063 adults interviewed for motor insurance and 12,214 for home insurance.
2. Mintel Vehicle Recovery – UK, September 2017.
3. Mintel Pet Insurance – UK, August 2017 and Mintel Travel Insurance – UK, February 2017.

Creating value for our stakeholders

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

Our core strengths

Customer focus

We put our customers at the heart of everything we do. Our brands, products and distribution channels aim to make insurance much easier to access and better value for our customers. Our fast and efficient claims service gives our customers the help they need, when it is needed.

Talented people

We invest in our people, encouraging everyone to aim higher. We do this so that our talented people across all parts of our business strive to improve and innovate, so that we can continue to deliver the products and services which meet the needs of current and future customers.

Brand power

We are Britain's leading motor and home insurer[1], offering our customers decades of experience, knowledge and service delivery via our trusted household brands. This scale provides a platform for new product development.

Data and technology

We are harnessing the power of technology to make life easier for both our customers and our people. Continuing our history of disrupting the insurance market, we aim to use technology to become even more customer-centric, learning from the wealth of data we possess as a result of being a leading insurer.

Capital and financial strength

We have a simple but highly cash-generative business model. Our proven underwriting discipline, claims excellence and cost control helps us meet our customers' needs whilst targeting sustainable returns for our shareholders.

Our services

- Motor
- Home
- Rescue and other personal lines
- Commercial

Reinvest in the business

See page 2 for our investment case

See page 30 for operating review

1. Measured by in-force policies.

Managing risk

Generating returns

We strive to make sure our business is well-governed and controlled. We manage our finances carefully and balance this with targeting sustainable returns for our shareholders.

Premiums

Net claims

Costs

Investment and other income

Profit

Sustainable value

Customers
We give customers products that best suit their needs and exceptional service throughout their relationship with us.

144.0pts
Net Promoter Score[2]

Employees
We invest in initiatives to develop our people, creating a high-performance culture based on diversity, continuous training and customer focus.

78%
engagement[3]

Communities
We are committed to supporting our employees' charitable work, reducing our environmental impact, and inspiring a generation of safer young drivers.

33%
of staff fundraised or volunteered on Company time

Shareholders
We aim to give our shareholders value by generating sustainable business profits, part of which we distribute as dividends.

35.4p
Dividend per share

Dividends

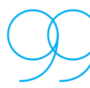
See page 34 for finance review

See page 14 for our strategy

2. See page 21 for explanation on NPS.
3. See page 28 for details on employee engagement.

Delivering sustainable growth

Returns to our shareholders remain a key focus in this challenging market environment. Cumulative dividends represent approximately 80% of the share price at the initial public offering.



Dear shareholders,

In 2017, the Group delivered profit before tax of £539.0 million (2016: £353.0 million). Continuing underwriting discipline, increasing operating efficiency, favourable claims results in the year and releases from prior year reserves have helped us achieve this commendable result.

Strategy

The Group's mission is to make insurance much easier and better value for our customers. The Board supports and challenges the Group's management to develop and execute a strategy which is aligned with this mission and positions the business to address the evolution of customers' needs, including taking advantage of significant changes in technology. The effective execution of our strategy requires a substantial and continuing change agenda to improve our digital offering and the agility of the organisation.

Dividends

In August 2017, the Group announced that the regular dividend would be rebased upwards to reflect the Board's confidence in the Group's earnings capability, its potential to generate strong cash flows, and the progress the business has made since the initial public offering ("**IPO**") five years ago when the Group's dividend policy was previously set. In line with this, the Board is recommending a final dividend of 13.6 pence per share. If approved, the total regular dividend of 20.4 pence per share will represent 39.7% growth on 2016's regular dividend (14.6 pence per share). In addition, the Board has resolved to pay a further special interim dividend of 15.0 pence per share to reflect the Group's strong performance in the year.

The Board's ability to return a substantially higher regular dividend to shareholders is despite the backdrop of a challenging economic environment during the UK's ongoing negotiations regarding its withdrawal from the European Union. Whilst the day-to-day operations remain substantially unaffected, the Group continues to monitor the consequences of the volatility of Sterling, inflation and uncertain financial markets.

Linking remuneration to performance

We remain committed to ensuring that executive pay is aligned with the Company's strategy of delivering long-term shareholder and customer value.

The Group achieved a return on tangible equity ("**RoTE**") of 21.7% for 2017. An increase of 3.3% (2016: a decrease of 9.4%) in the share price over the year to 381.7 pence (2016: 369.4 pence) at 31 December 2017, together with dividend payments, provided a total shareholder return ("**TSR**") of 8.1% for the year (2016: minus 1%). Over the past five years, shareholders have received a TSR of 152% compared to the FTSE 350 (excluding investment trusts) of 62%. The Group has continued to deliver very good results each year, which has enabled the Board to declare cumulative dividends, including special dividends, equivalent to approximately 80% of the IPO share price.

Solvency II

The Group uses its partial internal model ("**PIM**") to calculate its solvency capital requirement ("**SCR**"). Taking into account the final dividend and special interim dividend proposed to be paid in May 2018, the Group's 2017 year-end capital surplus amounts to approximately £0.86 billion above its SCR (2016: £0.91 billion above its SCR). This is equivalent to a solvency capital ratio of 162% (2016: 165%). The Board considers the appropriate Group risk appetite range to be 140% to 180% of

its SCR and expects the Group to operate around the middle of this range in normal circumstances where there is no material opportunity or threat.

This is intended to enable the Group to meet all of its operational, regulatory and rating agency requirements.

IT infrastructure

The Board continues to provide oversight of the programme of activity to upgrade and better integrate the major IT systems within the Group's technology infrastructure aimed at improving the digital offering, customer experience and operational efficiency. Whilst progress has been made in each of the three areas, implementation and integration of a range of new IT systems is inherently complex and challenging. The Group remains focused on building the right capabilities and will take the time necessary to do so. The Board's ongoing areas of focus include developing future capability for both customers and colleagues, and monitoring risks around the internal control environment, part of which is focused on the stability and security of the Group's IT systems.

Culture, conduct and regulation

The Group maintains active relationships with its insurance regulators through constructive dialogue. The Board promotes an open and collaborative culture, and provides oversight of the Group's conduct with customers. It oversees the Group's culture and the conduct policy, which aims to ensure that fair customer outcomes are achieved and that employees behave with integrity. The Group also has a Code of Business Conduct which sets out standards that our employees are required to adhere to (see page 60). The Board recognises that opportunities will arise to improve further the services offered to customers; and it has therefore encouraged a range of customer experience initiatives which are designed to deliver increased levels of customer satisfaction.

Board and Committee membership changes

Succession planning remains a key area of focus for the Board. In February 2017, Danuta Gray was appointed as a Non-Executive Director ("**NED**") and Mike Holliday-Williams was appointed as an Executive Director to the Board. Danuta was also appointed as a member of the Remuneration Committee in March 2017 and the Nomination Committee in August 2017. John Reizenstein was appointed as a member of the Investment Committee in July 2017. In November 2017, the Group welcomed Penny James to the Board as an Executive Director and CFO-designate, following the announcement that Penny will become CFO with effect from 1 March 2018 and that John Reizenstein will retire from the Board at the conclusion of the Annual General Meeting ("**AGM**") on 10 May 2018. I thank John very much for his outstanding achievements as CFO over the last seven years; his contribution to the success of the Group to date has been significant and I wish him the very best for the future.

Andrew Palmer, independent NED and Chair of the Audit and Investment Committees, has decided to step down from the Board on 10 May 2018, having served as a Director since 2011. His tireless work before and after the IPO has been invaluable to the Board and to the Group's senior management. He leaves us with our deepest gratitude and our best wishes for the future.

My introduction to the Corporate Governance report and the Nomination Committee report provide further information on these changes.

I would like to thank each member of the Board for their significant contribution, commitment and service; and look forward to working with them in 2018 as the Group continues to build on its success to date.

Employees

The Group's employees are fundamental to the Group's strategy and to ensuring a high level of service to our customers. I would like to thank each of them for their hard work, initiative and commitment to our mission. Their positive energy, embodiment of the Group's values and unwavering dedication to our customers helped our businesses progress over these five successful years, and has put us in a strong position for the future.

Michael N Biggs
Chairman

Governance highlights

Leadership

Your Board seeks to ensure that decisions are of the highest standard. It challenges strategic proposals, performance delivery and management responsibilities. See page 49.

Effectiveness

The effectiveness of your Board's and its Committees' performance is considered annually in an effectiveness review. See page 52.

Accountability

Your Board provides shareholders with an assessment of the Group's position and prospects. We monitor and review the effectiveness of the Group's risk management and internal control systems. See pages 22 and 56.

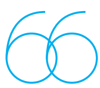
Remuneration

Your Remuneration Committee ensures a close correlation between creating value for shareholders, and remunerating Executive Directors and senior executives appropriately. See pages 57 and 74.

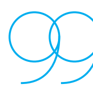
Relations with shareholders and stakeholders

Your Board maintains strong relationships and regular interaction with shareholders. Their continued support for the strategic aims is important. See page 57. Your Board also has regard to the interests of stakeholders. See page 59.

Making insurance much easier and better value for customers



This year's progress reflects the hard work of our people and our continued customer focus.



Q: How is Direct Line Group making insurance much easier and better value for customers?

A: I'm really proud that we're growing our brands and our customer base whilst continuing to deliver a strong financial performance. A lot of our growth is coming through the Direct Line brand, where we have put a huge amount of work into reinvigorating what we do for our customers. We know that insurance is not just about competitive prices; customers value great products and services as well as great prices. This year we've added even more propositions which are unique to Direct Line, including providing alternative accommodation should customers be unable to live in their home after an insured event, as well as an emergency plumber service. Our Green Flag brand has also grown fast, showing its effectiveness as a disruptor brand in the Rescue market. And we've continued to develop the digital journey through mobile devices, allowing personal customers to use their smartphones in a broader range of claims situations.

Q: How would you describe the Group's financial performance?

A: 2017 is the fifth successive year in which we've delivered a strong financial performance. The Group has a great track record of meeting the targets we publish and this gave us the confidence to extend some of our targets into the medium term. Investors I meet acknowledge that since going public in 2012 we have demonstrated consistently strong results, coupled in recent years with growth in the business – though of course they encourage us to not only sustain this but do better.

Q: What has driven the Group's dividends?

A: As announced in the 2017 half year results, the Board has rebased the regular dividend upwards, increasing the final dividend by 3.9 pence to 13.6 pence per share (2016: 9.7 pence). This reflects our confidence in our earnings and the progress we have made since the IPO in 2012.

Q: What role does IT investment play in your plans?

A: Technology is the backbone of our organisation and we've seen major changes in infrastructure and software over the last few years. Our profitability has enabled us to pay good dividends and also to continue to invest in technology. In 2017 we launched our new digital platform for small business customers using the Direct Line for Business brand. This addresses the fact that today's small businesses, particularly start-ups, find insurance complex and expensive and need policies and services that are tailored to the needs of their businesses. Meanwhile we are working on our core personal lines policy and related systems, bringing in best-in-class software aimed at delivering faster, better, digital customer experience at lower cost.

We have invested significantly in IT and data knowledge and capability. We have brought in new talent over the past two years across IT, IT security, digital and data to help achieve this. During the year, we decided that some of the investment undertaken as part of the improvement in IT capability would not deliver the targeted performance levels to meet its customers' expectations. Therefore, we decided to rework some elements of data storage and data flows. As a result we incurred an intangible asset impairment charge of £56.9 million in the year, reflecting capitalised costs of intangible assets that will no longer be utilised.

Q: What do you see as the greatest market opportunities and challenges?

A: I've already mentioned Direct Line for Business and Green Flag. There are other exciting opportunities ahead for NIG, where we are providing a great service to brokers serving the SME sector, and where we are investing in pricing capability as well as technology. In our Home business, we are doing innovative work with our NatWest partner to serve their retail customers better, and in Travel we are building a new operating platform as a foundation for developing both our direct and partner business. Of course the markets we operate in are extremely competitive and 2017 saw significant industry-wide challenges in the form of Insurance Premium Tax ("**IPT**") and changes to the personal injury discount rate. These challenges, coupled with the growing popularity of PCWs, have created a shoppers' market and I'm delighted with the success that our brands have enjoyed across the direct and PCW channels.

In the longer term, our core markets of motor and home and the products we are insuring are changing rapidly and while this brings challenges, it also presents many opportunities. That is why we are investing to stay ahead, for example through a number of strategic partnerships in the FinTech sector which position the Group for some of the disruption which we expect to occur. The most significant challenge in the long term is the potential for driverless cars to enter the mainstream market. We have a positive attitude to new car technology and believe it will make cars much safer, which would be a good thing for society while reducing the pool of risk which customers need to cover via insurance. We believe the insurance industry has a critical role to play in the analysis and adoption of the technology and we are therefore developing insight into the impact of automated driving systems on liability and claims. This is happening, for example, through MOVE_UK and StreetWise, a driverless car consortia which the Group has joined. We also have the benefit of our state-of-the-art repair network, which is investing to stay abreast of new car technology. If the risk pool declines as a result of the new technologies, we would expect the size of the Motor market to contract. In these circumstances we will need to continue to win more of it. With the insights we are gaining, and the relationships we are building, I believe we will be well-positioned to do that.

Q: It has been five years since the IPO. Can you describe the journey you have been on as an organisation? What have been the most significant changes over the last five years?

A: In many ways it seems like no time at all! I think that the fifth birthday has given us cause to reflect on not just a one year view but on a five year view of our progress. We have achieved a huge amount over that period. We are a people business and these achievements are the result of the efforts of our entire DLG team, all of whom have played a part in a fundamental change in our culture from that of a division of a large global bank to our own unique identity.

Key steps in this change have been our focus on the customer and on individual behaviours, our performance management system, investing in our leadership, our colleague share ownership scheme, and initiatives such as Idea Lab, which enable colleagues to be rewarded for saving the Company money.

All this leads to a high level of employee engagement, which rose again in 2017. Our full engagement score has gone up to 78% (five points higher than last year and 33 points higher than when we first ran the survey in 2014) and over 9,200 people (87%) took part in our DiaLoGue colleague survey this year. We are grateful that so many people participated, and we're delighted that our efforts in engaging and motivating our colleagues – who, importantly, our internal survey indicates feel that they are listened to and respected – continue to pay off. We want them to know that what they think and what they do really matters to the company.

One of the proudest moments for all of us in the last five years has been to write over four million Direct Line policies in 2017. This is the result of an alignment of our strategy, our insurance and marketing expertise and the customer focus of our employees.

Q: What is your outlook for the Group in 2018?

A: Looking beyond the external uncertainties like the weather, whiplash reforms and the changes to the personal injury discount rate, we have a good plan in place for our customers, shareholders and colleagues. Achieving a balance between all three has been central to our success since IPO and that continues to be our aim.

Turning to our performance beyond 2017, the Group targets a combined operating ratio of between 93% and 95% over the medium term, assuming a normal level of claims from major weather events and no further change to the Ogden discount rate, supported by reductions in our expense and commission ratios and reiterates our ongoing target of achieving at least a 15% RoTE. For 2018, we expect net investment income yield to be around 2.1%, with overall investment return in the region of £150 million.

Paul Geddes
Chief Executive Officer

Our environment

We operate in a dynamic environment and as such invest in evolving our business to meet the demands of changing customer needs, regulatory requirements and technological disruption. This enables us to serve our customers and manage claims to high standards.

Digitalisation & technology

Technology provides opportunities for insurers

- Digital technology is changing how customer needs can be met
- Data available to insurers is increasing as homes, vehicles and devices become connected
- Technologies including artificial intelligence and machine learning will enable better risk modelling, improved personalisation and enhanced customer experience
- Increased data and digital access brings a risk to information security

Our response

- We continued to invest and partner with innovative FinTech and InsureTech companies
- We continued to invest in our systems, digital and data capabilities including appointing a new Chief Data Officer
- We continued to pursue our ambitious IT transformation programme and enhanced our digital offering
- We developed a custom-built digital platform to provide a seamless journey for our RBS and NatWest partnership customers

>£218m
invested in UK InsureTechs in the first half of 2017[1]

Claims and premium inflation

Rising cost pressures for insurers and customers

- Motor insurance premiums continued to rise with pressure from increasing costs, regulatory changes and macroeconomic pressures
- Increased vehicle complexity, exchange rate impacts and inflation have contributed to rising repair costs
- Regulatory changes including those to the Ogden discount rate and the rise in IPT have added upwards pressure to the costs of insurance

Our response

- We continued to add to our accident and repair network and rebranded the network to DLG Auto Services
- We focussed on expenses reduction by using robotics and offshoring as well as investing in our fraud analytics capability
- We maintained our emphasis on achieving targeted loss ratios

On average
£44m
is paid out each day in personal motor and property claims in the UK[2]

Changing customer needs

SMEs represent a growing customer base with distinct needs

- The SME segment in the UK continued to grow, having grown by over 2 million businesses since 2002
- Technology and digital trends are enabling small businesses to reach a wider customer base and operate for longer hours, with fewer staff
- These same trends are changing how these businesses interact with financial services providers
- Small and micro businesses are behaving increasingly like consumers – looking for simplicity, speed and personalisation

Our response

- Launched Direct Line for Business new digital platform, targeting small and micro businesses

Small businesses accounted for
99.3%
of all private sector businesses at the start of 2017[3]

Car technology and automation

Opportunities and challenges in an evolving sector

- The automotive industry is undergoing dramatic change with improvements in in-car technology and the advent of electric, connected and autonomous vehicles
- These changes will give rise to opportunities and challenges for motor insurers. Access to data from connected cars may present a significant opportunity for insurers to evolve their products
- Over the longer term, autonomous vehicles could impact the nature of the risk being insured and the customers being served – as the risk shifts from the driver to the vehicle and more customers move from owning to renting cars

Our response

- Maintaining our industry-leading position in in-car technology with participation in the StreetWise project aiming to use artificial intelligence to put autonomous vehicles on Britain's roads by 2019
- Signed a letter of intent with Volkswagen Insurance Service (Great Britain) Limited covering five well known brands – Volkswagen, Audi, SEAT, Škoda and Volkswagen Commercial Vehicles

Over
85%
of all new cars are already classed as connected in the first half of 2017[4]

Brand strength

Brand is a key differentiator in a competitive environment

- Retention is a key driver of profitability for insurers, as the cost of acquisition is often higher than that of retention
- Brand strength has a material impact in driving purchase and retention[5]
- It is a critical enabler for selling direct which typically has better retention and profitability

Our response

- We believe investing in our brands and differentiating propositions is an effective strategy for success, with Direct Line brand policies passing 4 million in 2017
- The strength of our brands and propositions enabled us to operate successfully through the direct distribution channel, deliver a superior service to our customers, great returns to our shareholders and gave us the scale and expertise to operate effectively in the partnership and aggregator channels
- We launched two headline propositions for Direct Line and the "Drive on" proposition for Churchill
- New management appointed for Green Flag and a new advertising campaign highlighting its challenger status

93%
of customers believe that claims efficiency and trustworthiness are important[5]

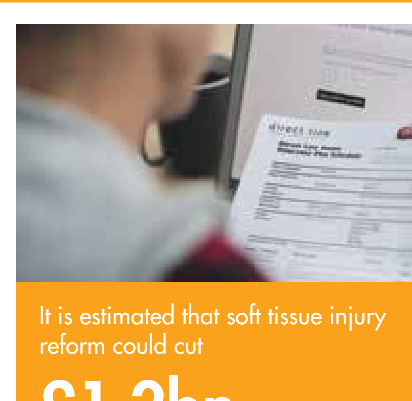
Regulation and legislation

A dynamic and complex regulatory environment

- The insurance regulatory and legislative environment continues to change at a rapid pace, with changes including:
  - new rules to promote price transparency by requiring disclosure of the previous year's premium on renewal
  - increase in the IPT rate
  - reduction in the personal injury discount rate
  - announcement of the Civil Liability Bill aimed at reducing the cost of soft tissue injury claims
- The vote to leave the EU has continued to bring a level of uncertainty over regulation, in particular on Solvency II

Our response

- We continue to keep abreast of regulatory changes and engage continuously with regulators

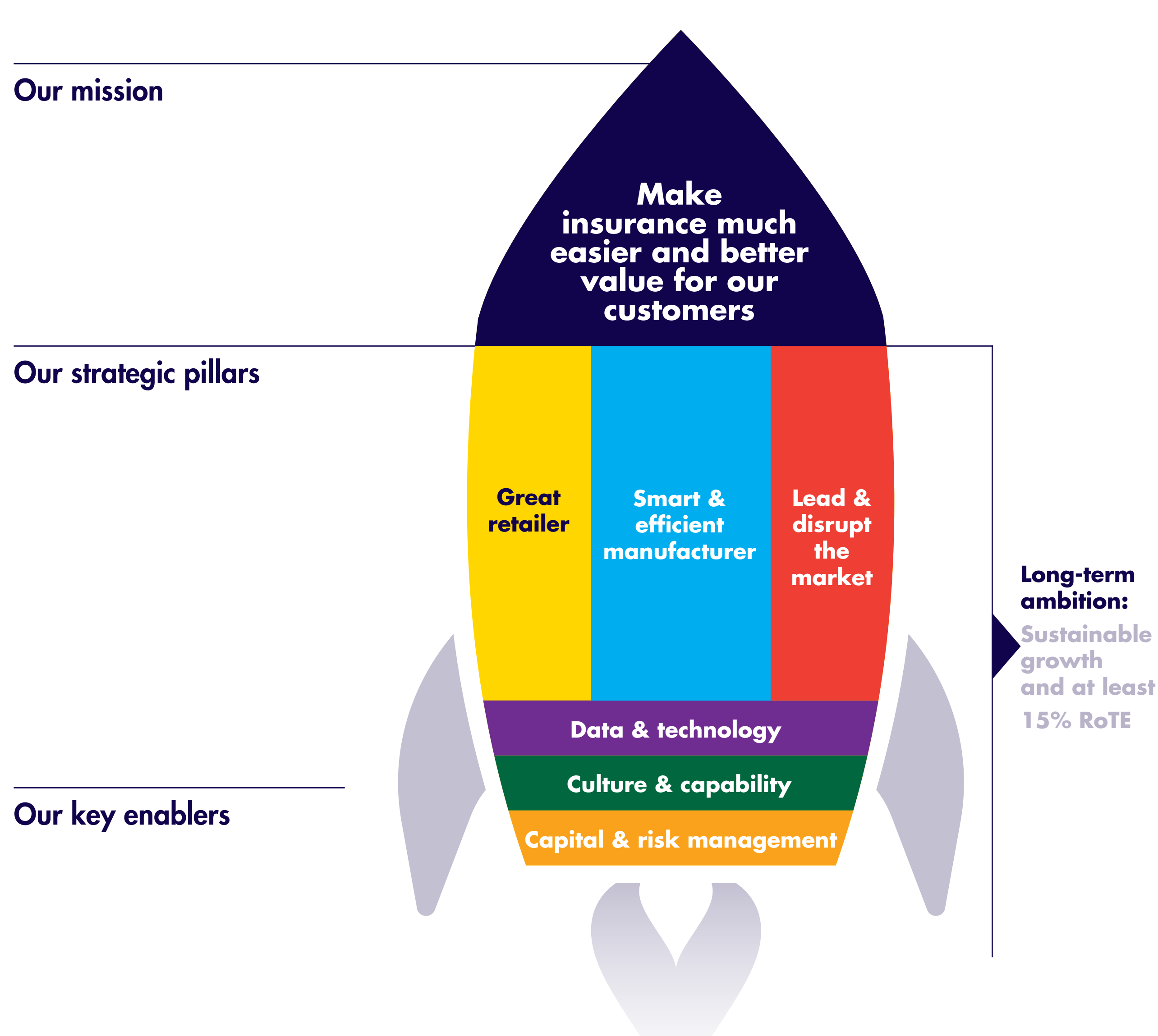


It is estimated that soft tissue injury reform could cut
£1.2bn
per year from insurance costs[6]

Notes:
1. Accenture
2. Association of British Insurers
3. Business statistics, December 2017 – UK Government
4. PwC
5. Morgan Stanley
6. Ministry of Justice

Growth ambition over the longer term

We have shown ourselves to be a business that can deliver great things for our customers through our brands and at the same time deliver excellent returns for our shareholders. As we embrace the future we will do so with our consistent strategy which targets sustainable growth. As a forward-looking and proactive insurer we are well-positioned to keep pace with technological change and the opportunities it creates for us to grow the business and continue our history of disrupting the insurance market.



Great retailer

Compelling brands, propositions and customer experience to meet diverse and long-term customer needs

We aim to make it easy for our customers to access our products and services at every stage of their journey. This includes increasing online policy servicing options for our customers including claims, enhancing the customer experience from purchase through to claims and evolving telephone sales and servicing by investing in next-generation customer systems.

We focus on training our contact centre employees to understand and better respond to our customer needs. We also invest in our brands, which are a key differentiator in a competitive environment.

Customer satisfaction is critical to the success of our business and our brand. As such we link our customer satisfaction scores to our executive remuneration through the Annual Incentive Plan ("**AIP**").

Our response

- The investment in our brands and propositions continues to deliver benefits, with the Direct Line brand in-force policy count passing four million customers this year
- We launched two headline propositions in Direct Line with Onward Travel in Motor that promises to keep customers moving after an accident, by arranging and paying for a taxi to continue their journey. We are the only insurer who offers this end-to-end service and since launch, our customers have travelled over 46,000 miles in taxis organised by Direct Line
- In Direct Line Home, we launched our Alternative Accommodation proposition, providing hotels for customers within one hour, following incidents which left their homes uninhabitable
- We are planning to continue to "supercharge" Churchill with new propositions, such as "Drive On" launched this year, assisting customers to replace cars if theirs is written off
- We continue to grow in Commercial through our business brands NIG and Direct Line for Business. Direct Line for Business continued to grow throughout the year in all product areas. In particular, we've expanded our business to offer better value, personalised insurance products to different types of small businesses
- We are backing Green Flag to disrupt the rescue business through our smart, connected network and embracing our challenger status. To support this ambition, this year we recruited a new Managing Director for Rescue and launched a fresh advertising campaign, with further investment in Green Flag planned in 2018
- Frontline colleagues continue to have a high focus on delivering great customer experience with 85% of customers surveyed (1 million + responses) in 2017 rating our people's performance as 9 or 10 out of 10
- Our customer satisfaction scores for the Direct Line brand have seen an 8% improvement from last year, with Churchill seeing a 5% improvement over the same period

Find out how this responds to market drivers on pages 12 and 13

Smart & efficient manufacturer

Efficiency and flexibility to deliver better claims and customer service at lower cost

We aim to improve efficiency and effectiveness across the organisation. To do this we continue to deliver transformation initiatives, while also investing in capabilities to enhance the quality and effectiveness of our claims operations.

Customer satisfaction with and the quality of our claims process are a crucial part of our brand and help differentiate us from our competitors. As such we link our senior executives' remuneration to customer satisfaction through the AIP.

Our response

- This year we centralised procurement and supply chain management into a single strategic function to enable us to be more proactive in driving performance and value from our supply chain. This helped us lower the total cost of hire car provision, escape of water repairs and our IT infrastructure costs
- We have implemented robotics process automation as one of our initiatives aimed at reducing our expense ratio. We now have 80 robots managing over 30 processes of varying complexity, with over 600,000 transactions completed this year. Next year we plan to expand our robotics programme which currently has the infrastructure to support an additional 170 robots
- We have also invested in our fraud analytics capabilities, moving some of our data and analytics to an agile, cloud-based infrastructure, enabling real time fraud identification and management, as well as the use of wider datasets
- We continued to expand our accident repair network, with the addition of a new garage, bringing the total to 19 across the country. These have enabled us to control indemnity expenditure better while delivering an improved customer experience. To demonstrate our confidence in the service our repair network delivers, we've rebranded our repair network as DLG Auto Services
- We continue to monitor and control our costs carefully as part of the day-to-day running of the business, to help enable our expense ratio to reduce as the business grows
- We have extended our distribution reach into the strategically important motor manufacturer space: our partnership with PSA Finance UK (part of Groupe PSA, owners of the Peugeot and Citroën brands) and our introducer arrangement with Tesla, positions the Group as one of the leading motor partnership insurers in the UK

Lead & disrupt the market

We seek to maximise existing growth opportunities while creating and driving future areas of value

We aim to remain a leading competitor in our chosen sectors by providing quality propositions and value for money. Where there are opportunities, we will look to launch new and exciting products and services with the aim of putting us at the forefront of disruptive changes.

Our response

- When Direct Line was first launched, we disrupted a broker-led personal lines market – now we are looking to do the same for the Commercial small and micro business segment. This year, under the Direct Line for Business brand, we successfully launched the first two of our new, fully personalised insurance products for the Hair & Beauty and the Bed & Breakfast trades. Products can be tailored by the customer, allowing them to create a policy that's just right for them and only paying for what they need. Next year we will continue our expansion with the launch of further personalised insurance products for different types of business
- We've continued to make good progress on developing alternative pricing approaches using machine learning capabilities. These are intended to help us increase our competitiveness at good loss ratios

Data & technology

Harness the power of technology and the scale of our data

We aim to harness the power of technology to make things easier for our customers and our people. By implementing integrated systems that are flexible and efficient, over time we aim to reduce our expense ratio while improving customer interactions such as self-service. We also enjoy a wealth of data from being a major insurer with a large number of policies, which we can use to make our business better for our customers.

Our response

- We continued to invest in our data science capability with the appointment of a new Chief Data Officer and are focussing on improving our data architecture and driving further value from the data we hold
- We've developed a custom-built digital platform to securely interface with our partners, including RBS, NatWest and other third parties, allowing us to provide a seamless customer journey
- We are planning to expand our digital platform to connect with more datasets, enabling us to improve our customer experience and improve the quote and buy journey
- We continue to deliver our ambitious IT transformation programme by improving our digital offering for our customers through self-service options and enhancing the customer experience
- In 2017 a new Direct Line brand initiative – Fleetlights partnered with the Caister Volunteer Lifeboat Service, making them the first search and rescue team in the world to use our high-performance, pioneering semi-autonomous drone technology to save lives at sea. We also launched Smarter Crossings – the world's first responsive road – using light-emitting diodes that can react to the traffic, the people around it and the time of day, helping to keep road users safe
- We continue to build on our industry-leading position in understanding the impact of in-car technology on our industry. In 2017, we joined the StreetWise project, with the UK Government and Artificial Intelligence developers, which aims to use artificial intelligence to put autonomous vehicles on Britain's roads by 2019. Our Shotgun app was launched with the aim of saving lives and making Britain safer. The app, aimed at under-25s, uses telematics and gamification to reward safer drivers
- This year also saw the launch of our car maintenance service proposition for Green Flag, giving our customers access to a network of garages at discounted rates through our partner Roadserve
- In Home, we took an equity stake in Canopy, a rental market disruptor offering an alternative to costly security deposits that are hindering 'Generation Rent'

Driverless cars

We positively embrace technology and welcome developments in automated driving. Driverless technology will impact all road users and bring new insurable risks to the market. As the UK's largest motor insurer, we play a crucial role in this innovation and are backing projects that aim to bring this technology safely to the market. By embracing these technologies early on, we will be able to deliver the motor insurance our customers truly need.

Direct Line for Business

In 2017 we launched a technology platform that enables small business customers to tailor policies to their requirements. First launched through Hair and Beauty insurance, this "pick and mix" approach delivers more personalised insurance, and we are rolling it out across other commercial lines.

Culture & capability

Build on our people’s potential

We believe investing in strong development and employee engagement leads to better business performance and a better customer experience. We continue to invest to ensure our people are highly engaged, through targeted interventions at all levels of the organisation. As such we have diversity, engagement and succession targets in the AIP, an important component of our senior executives’ remuneration.

Our response

- Our employee engagement has remained high, improving on last year’s already strong result in our engagement survey. We look to retain the strong levels of employee engagement through a combination of local team action planning and top-down activity
- We’re improving the quality of career conversations by implementing simplified performance and development processes and increasing our people managers’ ownership of performance conversations and outturns
- In support of this, over 600 of our people managers have attended our Engage programme, a three-day residential course, helping them develop deeper and more authentic relationships with their teams and colleagues
- Our focus on open and honest conversations led to us speaking to over 650 of our people managers about mental health at our November 2017 leadership conference, initiating a dialogue on this important subject and progressing our value of “bring all of yourself to work”
- We are also focussed on investing in our future at all levels of the organisation. We made a series of appointments and promotions to the Strategic Leadership Team with the dual purpose of capability and succession planning
- Early talent continues to be a significant focus for us with the second year of our Graduate and Apprentice Schemes – bringing the number of graduates in the business to over 100, and apprentices to over 200. The graduate scheme gives a broad understanding of our business to our graduates in preparation for their advancement towards leadership roles
- We are also progressing a broad diversity and inclusion agenda through a range of activities, including signing the Women in Finance Charter and sponsoring the Dive-In Festival for Diversity & Inclusion in insurance
- We will continue to embed diversity and inclusion in our culture and talent processes, enabling our staff to “bring all of themselves to work” and continuing the good progress made on gender mix at senior levels

“This course was unlike any leadership course I have ever been on, with a fresh, different approach.”
Sheila Brudenell, Counter-Fraud Operations, Bromley

Capital & risk management

Strong foundation of capital and risk management

Our approach to capital and risk management is to maintain an appropriate level of capital and solvency in line with the risk appetite agreed by the Board to support our business, while aiming to grow dividends in line with our overall business growth.

Our response

- We rebased our dividends upwards to reflect the Group's confidence in our future earnings potential and the progress made since our IPO five years ago. We aim to grow the dividend in line with business growth
- We also announced refreshed medium-term targets in our half-year results, including targeting around the middle of our 140% to 180% solvency capital ratio range
- We proposed a major Solvency II model change, which was subsequently accepted by the Prudential Regulation Authority ("**PRA**")
- We restructured our debt through the issue of Tier 1 notes and the buy-back of older, more costly debt. As a result we have been able to reduce our interest payments, increase our flexibility and spread the maturity dates of the debt we hold
- We continued to work on embedding risk management across our organisation and this year we launched two internal campaigns to support this
- We also continue to monitor our external environment for risk and look to put mitigating actions in place as required. This year we performed an ad hoc Own Risk & Solvency Assessment ("**ORSA**") in response to the change in risk profile as a result of the decrease in the Ogden discount rate
- We recognise the strategic value and competitive advantage that strong risk management can provide and continue to work to drive ownership of risk management across the Group
- We purchase reinsurance to reduce volatility of earnings, facilitate effective capital management and transfer risk that is not within the Group's risk appetite. This includes purchasing reinsurance to protect against large claims for catastrophe, property risk and motor claims. This year, we placed a major proportion of our catastrophe programme on a fixed price for three years.

"The high-energy, interactive delivery encouraged me to take some valuable time to look at my world differently."
Elizabeth Fairburn, Claims Response, Leeds

Engaging our people

We are committed to investing in our people. Our newly launched "Engage" programme is designed to energise our managers and build a working environment to be proud of. The aim is to equip managers with the tools and techniques to build high-performing teams, and together deliver outstanding performance.

640

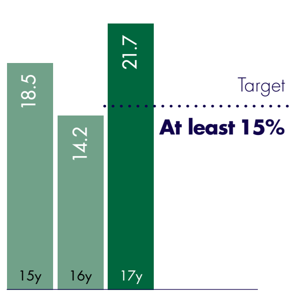
people managers participated in Engage training in 2017

Delivering strong performance

These key performance indicators assess our performance against our strategy.

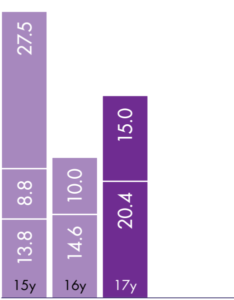
Read more about our rewards for performance on page 74. For definitions, see the glossary on pages 174 to 176

Return on tangible equity[1] (%)



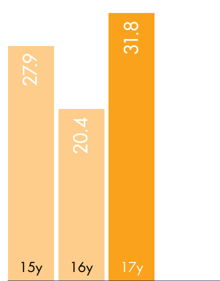
21.7%

Dividend per share (pence)



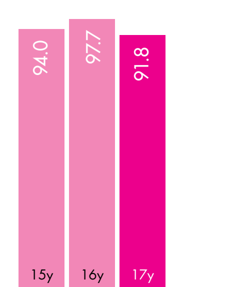
35.4p

Basic earnings per share (pence)



31.8p

Combined operating ratio (%)

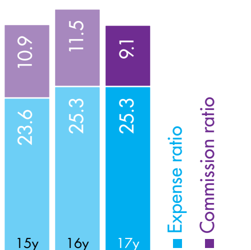


91.8%

	Return on tangible equity	Dividend per share	Basic earnings per share	Combined operating ratio
Definition	The return generated on the capital that shareholders have in the business. This is calculated by dividing adjusted earnings by average tangible equity.	The amount of cash paid to shareholders from the Group's profit.	This is calculated by dividing the earnings attributable to shareholders by the weighted average number of Ordinary Shares in issue.	A measure of financial year underwriting profitability. It is the sum of the net claims, commissions and expenses divided by net earned premium. This excludes instalment and other operating income, and investment return. A combined operating ratio ("**COR**") of less than 100% indicates profitable underwriting.
Aim	We aim to achieve at least a 15% RoTE.	We have a progressive dividend policy and aim to grow regular dividend in line with business growth. Additionally, we look to return surplus capital to shareholders when appropriate.	We have not set a target. However, growing earnings per share is considered an indicator of a healthy business.	We aim to make an underwriting profit. For 2018, we expect to achieve a COR in the range of 93% to 95% for Ongoing operations, assuming a normal level of claims from major weather events and no further change to the Ogden discount rate.
Performance	See Finance review page 38	See Finance review page 39	See Finance review page 38	See Finance review page 36
Link to Directors' remuneration	We base the Long-Term Incentive Plan ("**LTIP**") awards partly on RoTE over a three-year performance period.	We base LTIP awards partly on relative TSR performance, which includes dividends. Directors also receive dividends on their beneficial shareholdings and accrue these on unvested LTIP awards.	This is a broad measure of earnings and reflects the results of the Group after tax. We base part of the AIP awards on profit before tax and earnings per share is closely linked to this.	We base part of the AIP awards on profit before tax. COR is closely linked to this.

Note:
1. See glossary on pages 174 to 176 and APM in appendix A from page 177.

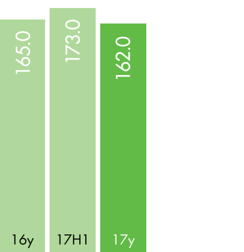
Expense and Commission ratios[1] (%)



Expense ratio: 25.3%

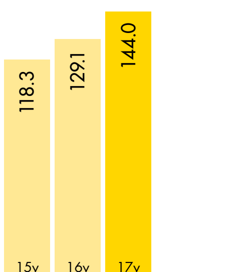
Commission ratio: 9.1%

Solvency capital ratio[2] (%)



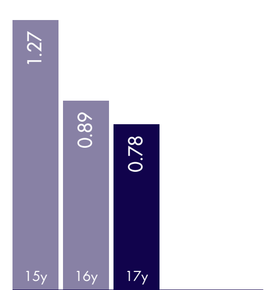
162.0%

Net promoter score[3] Direct Line brand (points)



144.0pts

Customer complaints[4] Principal underwriter[5] (%)



0.78%

Definition

Expense and Commission ratios: A measure of the cost of doing business, including paying our people, marketing expenses, and spending on infrastructure and IT. This includes the costs we incur handling claims and any commissions we pay to brokers or partners.

Solvency capital ratio: A risk-based measure expressing the level of capital resources held as a percentage of the level of capital that is required under Solvency II.

Net promoter score: Net Promoter Score ("**NPS**") is an index that measures the willingness of customers to recommend products or services to others. It is used to gauge customers' overall experience with a product or service, and customers' loyalty to a brand.

Customer complaints: The number of complaints we received during the year as a proportion of the average number of in-force policies.

Aim

Expense and Commission ratios: We aim to reduce our expense ratio during 2018, absorbing our investment in future capability. We also aim to deliver a lower commission ratio in 2018, normalised for major weather events.

Solvency capital ratio: We target a solvency capital ratio in the range of 140% to 180%.

Net promoter score: We aim to improve this to achieve strong levels of customer loyalty and retention rates.

Customer complaints: This measure indicates the level of customer service we provide. We aim to improve this over time.

Performance

Expense and Commission ratios: See Finance review page 37

Solvency capital ratio: See Finance review page 42

Net promoter score: Customer claims experience programmes and improved propositions have contributed to an increase in our overall brand score.

Customer complaints: While the proportion of complaints received improved on 2016 we recognise we have more to do to reduce these.

Link to Directors' remuneration

Expense and Commission ratios: Costs are considered and form part of the gateway measures[6] for the AIP awards.

Solvency capital ratio: Risk management within risk appetite, which includes an assessment of capital strength, and acts as a gateway for the AIP awards and underpin for LTIP awards.

Net promoter score: The AIP awards include a weighting to a balance of customer metrics, including NPS.

Customer complaints: The AIP awards include a weighting to a balance of customer metrics, including complaints.

Notes:
1. See glossary on pages 174 to 176 and Appendix A - APM from page 177.
2. Estimates based on the Group's Solvency II partial internal model.
3. On an aggregated 12-months rolling basis, with 2013 rebased to 100.
4. FCA complaints reporting requirements have changed for periods after 29 June 2016. Before 29 June 2016, only complaints resolved after 2 business days were classed as FCA reportable. From July 2016 all complaints resolved are classed as FCA reportable.
5. For the Group's principal underwriter, U K Insurance Limited.
6. See page 91 of Directors' Remuneration Report for explanation of gateway measures.

Managing our risks

We need to have a strong understanding of the nature and extent of the risks involved in pursuing the Group strategy; and, to enable our strategy's success, we must manage risk effectively and efficiently.

Managing risk in line with our strategy

Management, with oversight from the Board, is responsible for developing our strategy. Our strategic planning process aims to ensure we have developed clear objectives and targets, and identified the actions needed to deliver them, including the management of risk. The delivery of a strategic plan will, by its very nature, result in risks and therefore understanding and managing those risks appropriately is a key aspect of the strategic planning process. The Group's risk strategy is aligned with the Group strategy and supports business decision-making through the proactive identification, assessment and management of risks. The Group's risk strategy is consistent with our overall long-term ambition of sustainable growth and at least a 15% RoTE delivered while remaining within our risk appetite.

Our risk governance framework

The Board sets and monitors adherence to the risk strategy, risk appetite, and risk framework. The Board approves our strategy, risk appetite and policies, and the Board Risk Committee ("**BRC**") approves the Enterprise Risk Management Strategy and Framework ("**ERMF**"). The Board has established a risk management model that separates responsibilities into 'Three Lines of Defence'.

Our First Line of Defence is management who are responsible for owning and managing risks to achieve our business objectives on a day-to-day basis. The Second Line of Defence is the Risk function and is responsible for the design and implementation of the ERMF, and for providing proportionate oversight of and challenge to the business's management of risks, events and management actions. Group Audit is the Third Line of Defence, providing an independent and objective view of the adequacy and effectiveness of the Group's risk management, governance and internal control framework.

The Group's governance structure is set out in more detail in the corporate governance section.

Risk appetite

Our risk appetite statements define the risks we are prepared to accept to achieve our business objectives. The processes for setting risk appetite; particularly the cascade, assessment, mitigation and reporting of risk exposures against risk appetite; are documented in the Group's policies and underlying minimum standards. To monitor whether the business remains within risk appetite, we use key risk indicators ("**KRIs**").

We derive the KRIs from the risk appetite statements which are used to drive and monitor risk-aware decision-making.

These KRIs are qualitative and quantitative, and forward and backward-looking. We review our risk appetite statements and KRIs annually.

Our risk objectives and appetite

Risk objective	Risk appetite statement
Overarching risk objective	The Group recognises that its long-term sustainability depends on having sufficient economic capital to meet its liabilities as they fall due, thus protecting its reputation and the integrity of its relationship with policyholders and other stakeholders. As part of this, the Group's appetite is for general insurance risk, focusing on personal lines retail and SME insurance in the UK. The Group has appetite for non-insurance risks, as appropriate, to enable and assist it to undertake its primary activity of insurance.
1. Maintain capital adequacy	The Group seeks to hold own funds in the range of 140% to 180% of the internal model solvency capital requirement. The Group also seeks to maintain sufficient economic capital consistent with its strategic aim of maintaining a credit rating in the 'A' range.
2. Stable and efficient access to funding and liquidity	The Group aims to meet planned and unexpected cash outflow requirements, including those requirements that arise following a 1-in-200 years insurance, market or credit risk event.
3. Maintain stakeholder confidence	The Group has no appetite for material risks resulting in reputational damage, regulatory or legal censure, poor customer outcomes, fines or prosecutions, and other types of non-budgeted operational risk losses associated with Group conduct and activities. The Group will maintain a robust and proportionate internal control environment.

Viability statement

In accordance with provision C.2.2 of the UK Corporate Governance Code, the Directors have assessed the prospects of the Group for a period longer than the 12 months required by the going concern statement.

The Strategic report, on pages 1 to 43, sets out the Group's financial performance, business environment, outlook and financial management strategies. It covers how the Group measures its regulatory and economic capital needs, and deploys capital. You can find discussion about the Group's principal risks and risk management in this section. Note 3 to the consolidated financial statements starts on page 127 and sets out financial disclosures relating to the Group's principal risks. This covers insurance, market and credit risk; and the Group's approach to monitoring, managing and mitigating exposures to these risks.

Every year, the Board considers a five-year strategic plan and an Own Risk and Solvency Assessment ("**ORSA**") for the Group. The plan makes certain assumptions in respect of the competitive markets in which the Group operates, and the delivery and implementation of the new customer systems. Appropriate aspects of the strategic plan are stress-tested to understand and help set capital and other requirements.

When reviewing the strategic plan, the Board considered the Group's prospects over the five-year period that the plan covered and the conclusions of the ORSA, based on the Group's anticipated activities as set out in the strategic plan. This review included reviews of solvency, liquidity, assessment of principal risks, and risk management over a three year period, with a further two years of indicative planning. The one-year planning period has greater certainty, so it was used to set detailed budgets across the Group. Outcomes for the four-year period are less certain. However, the plan provides a robust planning tool for strategic decisions. The Board recognises that, in a strategic plan, uncertainty increases over time and, therefore, future outcomes cannot be guaranteed or accurately predicted.

Considering the Group's current capital and trading position, its principal risks, and the remaining four years of the strategic plan, the Board has a reasonable expectation that the Company and the Group can continue in operation, and provide the appropriate degree of protection to those who are, or may become, policyholders or claimants in the period to 31 December 2021.

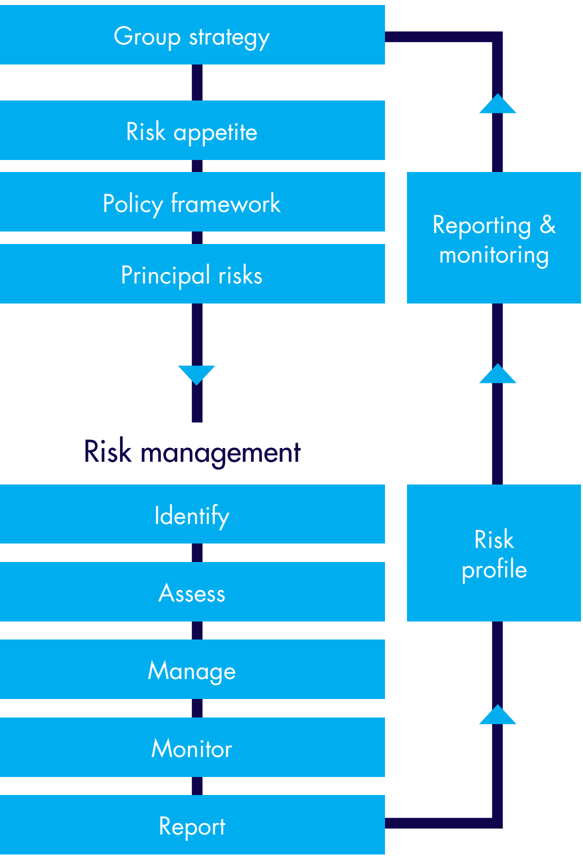
Our Enterprise Risk Management Strategy and Framework

This section sets out, at a high level, our approach to setting risk strategy and the ERMF for managing risks. It documents the high-level principles and practices to achieve appropriate risk management standards and demonstrates the inter-relationships between components of the ERMF – see diagram.

The ERMF enables us to manage the business with the necessary understanding of our risks and controls, as well as having appropriate oversight to manage risks proactively. The ERMF is aligned to the Three Lines of Defence model, and provides a comprehensive approach for managing our risks. Our Policy Framework is a central part of the ERMF, and includes policies and minimum standards which provide the context and risk appetite boundaries within which the business conducts its activities.

Our risk culture

Our risk culture underpins our business and decision-making, and helps us embed a robust approach to managing risk. Our risk culture is demonstrated in the understanding and business-wide use of the risk management systems and processes and through risk-aware decision-making. The Board is committed to promoting a culture of high standards of corporate governance, business integrity, ethics and professionalism in all our activities. An annual assessment of risk behaviours and attitudes is undertaken jointly by the Risk function and Group Audit and considers a range of factors influencing risk culture.



Principal risks and uncertainties

We assess robustly the principal risks facing us. Principal risks are defined as having a residual risk impact of £40 million or more on a 1-in-200 years basis, taking into account customer, financial and reputational impacts. There have been movements in our risk profile during 2017 primarily driven by the Ogden discount rate change and enhanced technology controls. There have been no material breaches of risk appetite.

Principal risks	Executive owner	Management and mitigation examples
Insurance risk • Underwriting risk • Reserve risk • Distribution risk • Pricing risk • Reinsurance risk The risk of loss due to fluctuations in the timings, amount, frequency and severity of an insured event relative to the expectations at the time of underwriting. See pages 127 to 129.	Chief Financial Officer, Managing Directors of Personal Lines and Commercial	• We estimate technical reserves using various actuarial and statistical techniques. Management's best estimate of total reserves is set at not less than the actuarial best estimate • Third party experts review the majority of our reserves • Underwriting guidelines are set for all transacted business, and pricing refined by analysing comprehensive data • Catastrophe and motor excess of loss reinsurance limits our exposure to events and large losses • We invest in enhanced external data to analyse and mitigate exposures • We set our reserves using the latest data and trends. In particular, the decision to reduce the Ogden discount rate has been reflected in the estimate of reserves
Market risk • Spread risk • Interest rate risk • Property risk The risk of loss resulting from fluctuations in the level and volatility of market prices of assets, liabilities and financial instruments. See pages 129 to 131.	Chief Financial Officer	• We ensure compliance with an investment strategy approved by the Board • We carefully diversify asset classes • We set limits on exposure to individual asset classes and the amount of illiquid investments • We tightly control individual credit exposures • We use risk-reduction techniques, such as hedging foreign currency exposures with forward contracts, and hedging exposure to US interest rates with swap contracts
Credit risk • Concentration risk • Counterparty default risk The risk of loss resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which we are exposed. See pages 131 to 135.	Chief Financial Officer	• Credit limits are set for each counterparty and we actively monitor credit exposures • We only purchase reinsurance from reinsurers with at least an A– rating. For liabilities with a relatively long period of time to settlement, this rating will be at least A+ • We have well-defined criteria to determine which customers are offered and granted credit
Operational risk • Information security risk • IT and business continuity risk • Outsourcing risk • Financial reporting risk • Model risk • Partnership contractual obligations risk • Strategic change delivery risk • Technology and infrastructure risk The risk of loss due to inadequate or failed internal processes, people, systems, or from external events. See page 136.	Specific members of the Executive	• We monitor operational risk activity in line with a Board-approved operational risk appetite • We have appropriate operational processes and systems, including detection systems for fraudulent claims • We are continuing to work to improve performance of our IT systems while focussing on developing future systems capability. With significant change underway, we are continuing to monitor risks associated with our IT systems' stability, cyber security, and the internal control environment • Our risk management framework is designed to enable us to capture risk information in a robust and consistent way • We monitor how risks are managed in the performance of outsourced and offshored activities

Principal risks	Executive owner	Management and mitigation examples
Regulatory and conduct risk • Compliance risk • Conduct risk The risks arising out of changes to laws, regulatory rules, policy or interpretation, or to supervisory expectations or approach, that have an adverse operational and financial impact as a result of reputational damage, regulatory or legal censure, fines or prosecutions, and any other type of non-budgeted operational risk losses, associated with the Group's conduct and activities.	Chief Risk Officer and Managing Director, Personal Lines	• We maintain a constructive and open relationship with our regulators • We use specific risk management tools and resources to help manage our exposure to regulatory risk • We have a strong culture of delivering on our commitments to our customers • Our conduct risk management framework is designed to deliver fair outcomes to customers and minimise our risk exposure • We carry out planned risk-based monitoring of customer processes as well as more targeted thematic reviews which consider strategic or regulatory projects
Strategic risk • Strategy implementation risk • Strategy formulation risk The risk of direct or indirect adverse impact on the earnings, capital, or value of our business, resulting from the strategies not being optimally chosen, implemented or adapted to changing conditions.	Chief Executive Officer	• We agree, monitor and manage performance against the Board-approved plan and targets • The Boards lead an annual strategy and five-year planning process which considers our performance, competitor positioning and strategic opportunities • We identify and manage emerging risks using established governance processes and forums

Emerging risks

Our definition of emerging risks is new or developing risks which are often difficult to quantify; they are also highly uncertain and are external to the Group. Emerging risks are identified by management and are recorded within an Emerging Risk Register. We report these to the BRC for review and challenge. Our emerging risks processes aim to:

- identify emerging risks on a timely basis;
- manage emerging risks proactively;
- mitigate the impact of emerging risks which could affect the delivery of the strategic plan; and
- reduce the uncertainty and volatility of our business' results.

We consider our main emerging risks to be:

Technological change in driving habits reduces consumer need for motor insurance

New car technologies, such as crash-prevention technologies and driverless cars, could significantly affect the size and nature of the insurance market, and the role of insurers.

In addition to our partnership with the Government on automated driving systems, the Group continues to build strong collaborative relationships, including with key manufacturers of driverless cars.

Changes to traditional insurance business models

New market entrants and changes in consumer expectations could result in significant changes to the structure of the general insurance market, and require us to update our business model. Our strategy, aligned to our mission to make insurance much easier and better value for our customers, is positioned to take advantage of changes in technology and customer behaviours, and building our partnership capabilities.

UK economy

The UK could enter a prolonged period of reduced growth due to the exit from the EU, potentially reducing insurance sales and the value of our investment portfolio. Whilst our operations are based mainly in the UK, we continue to monitor implications surrounding Brexit negotiations, and their uncertain outcomes, including: changes to the value of sterling which impact claims and non-claims supplier costs; inflation; recruitment and retention of people; potential changes to direct and indirect tax; and the regulatory impact on our capital position.

Climate change

Climate change could increase the frequency of severe weather events in the UK, and in particular, flooding claims costs. We continue to monitor changes in claims experience and consider weather trends as part of our pricing and underwriting approach.

Protecting Britain's young drivers

As Britain's leading car insurer, our Corporate Social Responsibility strategy is focussed on road safety. In particular, we are using our insight and expertise to make a measurable difference to young drivers in the UK.

Approach

Our approach to Corporate Social Responsibility ("**CSR**") helps us put society's interests at the heart of our business.

We partner with leading CSR organisations to ensure that we understand, prioritise, and respond to the sometimes competing needs of our different stakeholders across society.

We manage our approach through a CSR Advisory Group that comprises senior managers from across the business supported by our CSR team and backed by executive ownership. The CSR Committee oversees our approach.

You can find more details of our approach on the Group's website at www.directlinegroup.com, including our CSR Charter, policy framework, performance against last year's targets and targets for 2018.

To find out more about our CSR Committee, see page 68

Shotgun

With over

20,000

downloads, our Shotgun app is helping raise awareness of safer driving among 17 to 25-year olds

Road safety

We believe we can use our expertise and experience to help reduce the number of deaths and life-changing injuries on Britain's roads.

Safer young drivers

We have set an ambitious long-term aim of helping to cut deaths of young drivers in their first 1,000 miles of driving to zero. We will, of course, need to work with many other stakeholders to achieve this goal.

17 to 19-year olds are involved in 9% of all fatal and serious crashes, despite representing just 1.5% of all drivers. It's less well-known that, young drivers are more dangerous in their first 1,000 miles of driving after passing their test, before then improving. This is because young drivers are often over confident straight after passing their test. In addition, they are less experienced at spotting dangers or hazards on the road and often take more risks.

Our own claims experience confirms this, as we see that around one in five young drivers crash in the first year.

To help improve young people's driving behaviour, we identified three key insights that needed to be true if we wanted to help. The first was that we needed to be in the car with them, the next that we needed to provide feedback for improvement and finally that we needed to make the learning experience rewarding, fun and competitive.

We designed a free app, which tracks a person's driving. Once drivers have downloaded Shotgun to their phones, we monitor their driving for 1,000 miles, with each individual journey receiving tailored feedback. For example: "That was a bumpy ride! Accelerate gradually and be less heavy on the pedals. Let's turn this around."

To keep drivers engaged, we have put in place attractive rewards and created a leader board to allow people to see how their driving measures up against other drivers on the app. These leader boards can be personalised to allow people to compete with their friends.

There are six levels of reward. Drivers begin on level one, which enables them to get rewards like a free Amazon voucher. As their driving improves, taking on board their feedback they can progress through all levels and choose rewards from other leading brands. Level six rewards are higher value and experience-based, such as a free helicopter ride. The rewards are meaningful and help drive engagement with the app.

Marketing this product was not easy: we needed to grab the attention of young drivers who typically aren't that engaged with the subject of road safety. To do this, we concentrated our efforts on social media, generating awareness with some edgy viral content. This has worked well, helping us to raise awareness of our app with over a million 17 to 25-year olds and we have so far achieved over 20,000 downloads. We also made sure that a wider audience could find out about how Direct Line is taking a broader role in society and tackling meaningful issues. There was a wealth of PR-generated media coverage that spread the word to parents of young drivers and other opinion formers.

We are really proud to say that the app is already helping to make a real difference by improving road safety for young drivers. Our analysis of drivers using the app so far shows that for key areas such as speeding and braking, there has been a great improvement. Early indicators are that around one in three drivers have improved their smoothness, which means less hard breaking or tailgating is happening and one in four have improved their safe driving skills by reducing their speed. We know that these metrics have a high degree of correlation to overall safety and accident statistics, and so we are confident that Shotgun has already helped save people from death or serious injury.

Road safety partners

During 2017, we worked with various partners to highlight a range of road safety issues.

PACTS

In December, we launched our fourth Road Safety Dashboard with the Parliamentary Advisory Council for Transport Safety ("PACTS"). This pioneering tool uses Department for Transport statistics to produce an index that ranks the road safety record of individual parliamentary constituencies. MPs tell us they find the tool valuable. We also sponsored the PACTS Annual Westminster Transport Safety Lecture in the House of Commons where policymakers and campaigners come together to share ideas and best practice.

Department for Transport

We continue to engage with the Department for Transport on various topics, including telematics technology, driverless cars and road safety policy, providing written evidence to assist legislative proposals such as on the Department's Automated and Electric Vehicles Bill.

Brake

We maintained our partnership with road safety charity, Brake, and agreed a new three year programme to produce a series of topical survey reports on driver behaviour and attitudes. The reports include speed, in-vehicle distractions, advanced driver assistance systems and tiredness. Brake uses this research for its wider campaigning, education, community and professional engagement activities to raise awareness of road safety issues. We also share the results with the media and policymakers. At the beginning of the year we sponsored Brake's Parliamentarian of the Year Awards, which recognise Members of Parliament who have campaigned on road safety issues.

Our people

Our people strategy supports our business strategy, ensuring we have capable, skilled and engaged people who can help make buying insurance much easier and better value for our customers.

We continue to focus on building pride in the Direct Line Group, encouraging and celebrating the quality and diversity of our workforce. Various volunteer groups, such as our Employee Representative Bodies and Local Co-ordination Teams, increase our employees' voice within the organisation.

We gauge employee engagement through our Employee Opinion Survey. In 2017 we again significantly improved our engagement score from 73% in 2016 to 78%. The percentage of our employees who are proud to work for the Group also increased from 87% in 2016 to 91%, while 85% tell others that the Group is a great place to work (81% in 2016).

Diversity, inclusion and human rights

We continue to work towards an environment based on meritocracy and inclusion, creating a work place where we celebrate differences and we value our people for always being themselves.

Our diversity and inclusion practices are in line with the Universal Declaration of Human Rights. Our Ethical Code for Suppliers requires that all our suppliers adhere to the core International Labour Organization standards. We support the aims of the Modern Slavery Act 2015 and are committed to ensuring that modern slavery is not present in our supply chain. In accordance with the Act, we publish an annual statement on slavery and human trafficking on the Group website at www.directlinegroup.com.

In 2016, the Group signed up to the Women in Finance Charter. The Charter is a commitment by HM Treasury and signatory firms to work together to build a more balanced and fairer industry. Our pledge to the Charter reinforces our other initiatives such as our Diversity Network Alliance in promoting diversity and inclusion in our business. We report our progress against this commitment annually on the Group website www.directlinegroup.com.

You can find the ratio of female to male employees and the age profile of our employees at 31 December 2017 in the charts below.

Gender pay gap

Information relating to gender pay gap can be found on the Group's website www.directlinegroup.com.

Living wage

We comply with the principles of the Living Wage Foundation relating to our employees.

Anti-bribery and corruption

Our Code of Business Conduct sets out our most important legal obligations and helps colleagues follow key policies. We have an anti-bribery and corruption standard in place to ensure that the Group undertakes a consistent approach to bribery and corruption risks in line with risk appetite. We encourage a 'speak up' culture across our supplier base, and amongst our colleagues and have a whistleblowing policy in place. For more information see page 67 of the Board Risk Committee report.

Community

In response to the terror attacks in London and Manchester last summer, the Group donated to the British Red Cross UK Solidarity Fund.

Furthermore, following the terrible fire at Grenfell Tower, the Group is working with the Housing Plus Academy to develop a programme which begins to build resilience against such tragedies amongst residents of other tower blocks in the UK. Aside from giving tenants a voice, the programme is being shaped by research, analysis and expert opinion. The key output will be self-help training and materials for residents, though it is anticipated that a number of policy proposals will also follow. These outputs will be shared with Government and relevant agencies.

Volunteering and fundraising

We know that participating in fundraising and volunteering is linked to higher engagement levels amongst our people. In order to encourage our people to participate, we run a network of Community and Social Committees which are made up of local volunteers. These receive central funding and support from the Group to support Group-wide national appeals and create a programme of events and activities based on the interests of employees at their sites.

Examples of activities include employees manning our call centres to take pledges for appeals such as Children in Need, supporting national appeals such as the World's Biggest Coffee Morning in aid of Macmillan and organising quiz nights, fun runs, masquerade balls, festivals, cake sales, charity football matches and more to raise thousands of pounds for local causes.

We encourage all employees to volunteer individually or as a team through our 'One Day' initiative.

Our Employee Opinion Survey revealed that 33% of staff volunteered or fundraised in company time last year. Our target for 2018 is to at least maintain this level of engagement.

Matched giving and grants

We believe that our people's feelings about working for the Group are linked to our reputation in the community and we therefore try to align our approach to giving more generally with their interests. In 2017, our employees donated £151,000 through our payroll giving scheme and we donated a further £104,000 in matched giving. We also provided £66,000 in grants to organisations for which our employees fundraise or volunteer.

Environment

Emissions

You can find information on Group-wide greenhouse gas ("**GHG**") emissions in the chart below – and more details of our emissions in the Directors' report on page 102. We are targeting a 57% reduction in absolute GHG emissions (scope 1 and 2) by 2020 against a 2013 baseline.

Energy use is the main cause of our emissions. In absolute terms, we have reduced our emissions significantly after rationalising and implementing an energy-savings plan across our estate over the last five years. This covered building management, air-conditioning, heating and lighting, for instance. We are targeting a 30% like-for-like reduction in the Group's energy use by 2020 against a 2013 baseline.

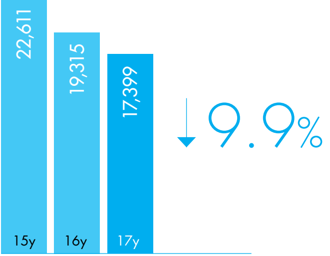
We communicate the details of a carbon management programme through the Carbon Disclosure Project and this year achieved a rating of 'B'.

Throughout 2017, we have maintained our commitment to sourcing 100% of the Group's electricity from renewable sources.

Waste

We continually seek opportunities to improve our systems for managing waste. In 2017, the Group recycled 72% of its waste (80% in 2016). This year-on-year fall is due to a 58% reduction in paper waste, which is 100% recycled. Excluding paper, the Group recycled 60% of its waste (54% in 2016). 98% of our waste, including recycling is diverted from landfill.

Greenhouse gas emissions[1] (tonnes)



Note:
1. This excludes discontinued operations, the Group's former International division. Total Group emissions for 2015 were 23,143.

Personal Lines

Motor

Highlights

- A leading British personal Motor insurer by in-force policies
- In-force policies increased by 3.8% with growth in own brands maintained in each quarter
- Gross written premium increased by 8.5% with own brands increasing by 11.4%
- COR improved by 14.4 percentage points due to the non-repeat of the substantial charge incurred in 2016 as a result of the reduction in the Ogden discount rate
- Operating profit improved by £215.4 million to £364.5 million, due to the non-repeat of the £150.3 million Ogden charge in 2016. Other prior-year releases were lower year on year, albeit large bodily injury claims developed favourably

Performance highlights

	2017	2016
In-force policies (thousands)	4,019	3,873
Of which own brands	3,845	3,642
Gross written premium	£1,670.4m	£1,539.1m
Loss ratio	60.9%	74.9%
Commission ratio	2.5%	3.2%
Expense ratio	28.5%	28.2%
Combined operating ratio	91.9%	106.3%
Operating profit	£364.5m	£149.1m

Performance

Motor in-force policies increased by 3.8% to 4.0 million during 2017, primarily due to growth in own brands. This was supported by higher levels of new business and higher levels of customer retention. Investment in brand differentiation continued in 2017, and helped drive the strong performance in Direct Line. Motor gross written premium increased by 8.5% to £1,670.4 million as a result of higher volumes and higher average premiums.

Motor risk adjusted prices increased by 9.5% in 2017 while risk mix reduced by 3.2% reflecting the way the Group deployed Ogden pricing changes which were in line with claims experience. As a result, Motor average premium[1] grew by 5.9% in 2017. The Group traded well throughout 2017 and benefitted from its reinsurance programme which was fixed prior to the Ogden discount rate change. Motor also benefitted from better claims experience in 2017 compared with the Group's long term view of claims inflation. These two factors enabled the Group to grow policy count and premiums at attractive margins.

The market continued to experience a high level of shopping behaviour following the change to the Ogden discount rate, IPT increases and the introduction of last year's premium disclosures. Market premiums increased during 2017, albeit slowing in the second half, due to better claims experience.

The COR was 91.9% (2016: 106.3%), a significant improvement due to the non-repeat of £150.3 million of the Ogden charge incurred in 2016. Excluding the impact of Ogden in 2016, the COR improved due to strong growth at improved margins. Motor also benefitted from a £49 million reserve release after a detailed review in H1 of the Group's Ogden provision within case reserves. Other prior-year releases were lower year on year, albeit large bodily injury claims developed favourably. The expense ratio increased slightly due to a higher intangible asset impairment of £56.9 million (2016: £39.3 million). The commission ratio improved 0.7 percentage points compared with 2016.

The current-year attritional loss ratio improved by 4.4 percentage points to 79.7% (2016: 84.1%). This reflects strong trading in 2017, the benefit of the Group's reinsurance arrangements renewed prior to the Ogden discount rate change announcement in February 2017 and better than expected claims experience.

While bodily injury claims frequency was better than expected in 2017, claims severity inflation, particularly in relation to damage perils, remained a headwind. Overall, claims inflation in 2017, excluding Ogden, was below the Group's expected long-term average of 3% to 5% per annum.

Operating profit was £364.5 million, higher than the prior year, due to the non-repeat of the £150.3 million Ogden charge, the £49 million reserve release and a reduction in commission costs. These positive effects were offset by lower other prior-year reserve releases.

The excess of loss reinsurance programme renewed on 1 January 2018 at a somewhat increased cost reflecting the reduction in the Ogden discount rate and at a level within the Group's plans and risk appetite. The Group renewed all layers, but retained 10% of the first risk layer (£2 million excess £1 million). This was a successful renewal in an uncertain climate reflecting the Group's historically strong performance and financial position.

The Group already has a partnership with PSA Finance UK (part of Groupe PSA; owners of the Peugeot and Citroën brands) and an introducer relationship with Tesla, and the Group has recently signed a letter of intent for a partnership arrangement intended to be for five or more years with Volkswagen Insurance Service (Great Britain) Limited covering five well-known brands – Volkswagen, Audi, SEAT, Škoda and Volkswagen Commercial Vehicles.

Regulatory

The Group has continued to operate within a highly dynamic and evolving regulatory landscape, particularly in the UK motor insurance market where a number of reviews and initiatives, including those that have been announced, by the UK Government, the Ministry of Justice ("**MoJ**"), the Financial Conduct Authority ("**FCA**") and the PRA. On 23 February 2017, the Government announced measures to reduce the volume and cost of soft tissue damage 'whiplash' claims and stated its expectation that this will see a reduction in motor insurance premiums of £40 on average. On 27 February 2017 the Lord Chancellor announced a reduction in the Ogden discount rate to minus 0.75% with effect from 20 March 2017. The Group has also been engaged in the consultation to consider options for reform concerning the discount rate.

Note:
1. Average incepted written premium excluding IPT for total Motor for year ended 31 December 2017.

Home

Highlights

- A leading British personal Home insurer by in-force policies
- Own brands in-force policies increased by 2.0%; overall reduction in in-force policies of 3.8%, primarily due to partnerships
- Gross written premium was 4.2% lower primarily due to partnerships, while own brands increased by 1.2%
- COR increased by 4.4 percentage points to 89.4%
- Operating profit was £128.8 million, compared with £166.7 million in 2016. The reduction reflected substantially lower prior-year reserve releases and higher costs from escape of water ("**EoW**") claims

Performance highlights

	2017	2016
In-force policies (thousands)	3,248	3,378
Of which own brands	1,794	1,759
Gross written premium	£799.1m	£834.4m
Loss ratio	50.6%	40.7%
Commission ratio	17.7%	22.6%
Expense ratio	21.1%	21.7%
Combined operating ratio	89.4%	85.0%
Operating profit	£128.8m	£166.7m

Performance

The Group's focus on being a great retailer was demonstrated again with the launch of another Direct Line Home proposition in 2017 with 'Emergency Hotel sorted within one hour'; in the event of a major home fire, the Group provides rapid support to its customers at the point of need. Propositions such as this continue to differentiate Direct Line from its peers. The Group's investment in its digital capabilities has strengthened its partnership capabilities as demonstrated by a faster quote and buy journey that its partners RBS and NatWest can now provide to their customers, increasing new business sales by 50% in 2017.

The change in distribution of Home's insurance business from partners to PCWs continued in 2017, increasing market price competitiveness and commoditisation. The Group remained competitive across all channels and successfully grew its PCW policies in 2017 at attractive margins, helping to support the strong profitability of the category.

In-force policies for Home own brands increased by 2.0% to 1.8 million over 2017, and gross written premium grew by 1.2%. Partnership in-force policies and premiums continued to fall in line with previous years.

Home own brands maintained competitiveness in 2017. The Group was quick to adjust new business prices to reflect claims inflation, and due to its strong propositions and improved competitiveness, wrote higher new business volumes. Total own brands risk adjusted prices were 2.6% ahead of prior year. Higher new business growth, particularly through PCWs led to a reduction of 1.3% in Home own brands average written premium[1]. As expected, renewal premiums continue to experience some reduction year on year due to channel mix moving towards lower premium PCW and web channels, whilst strong retention enabled policy renewals to grow year on year.

The market continued to experience a high level of shopping behaviour following IPT increases and the introduction of last year's premium disclosures. Market new business premiums increased in 2017 albeit not reflective of claims inflation.

The Group's Home partnership with Nationwide ended in December 2017 when new business ceased to be written. Existing in-force polices will run off during 2018.

The COR increased by 4.4 percentage points primarily as a result of a higher loss ratio, partially offset by a reduced commission ratio. The loss ratio increased 9.9 percentage points compared with 2016, mainly as prior-year reserve releases were lower than for 2016 at £23.7 million (2016: £75.9 million), as 2016 benefitted from significant releases from the reserves established following the storms of late 2015. The impact of major weather events in 2017 was slightly lower at approximately £13 million (2016: £18 million), lower than the normal annual level of claims costs expected from major weather events of approximately £65 million. Based on planned volumes for 2018, the Group's current assumption of a normal annual level of claims costs from major weather events is approximately £55 million.

The current-year attritional loss ratio, excluding claims costs from major weather events, was 4.2 percentage points higher than in 2016. This was predominantly driven by elevated EoW claims inflation costs and a change in channel mix. Claims, pricing and underwriting actions taken since Q1 2017 have been on track to reduce claims inflation to a more normal level.

The decrease in the commission ratio of 4.9 percentage points to 17.7% primarily reflected lower profit share payments to partners, as a result of lower prior-year reserve releases, a higher current-year attritional loss ratio and changes to partnership arrangements business mix.

Operating profit of £128.8 million decreased by £37.9 million due to elevated EoW claims inflation and lower prior-year reserve releases, partially offset by a reduced commission ratio.

The Group's focus on capital and risk management led to a successful renewal of its catastrophe reinsurance programme in July 2017, for the first time with a fixed rate three year arrangement for approximately 60% of its programme, providing more certainty over the costs it will incur on the majority of its programme until 2020.

Note:
1. Average incepted written premium excluding IPT for Home own brands for year ended 31 December 2017.

Rescue and other personal lines

Highlights

- In-force policies for Rescue reduced by 1.5% primarily due to lower partner volumes
- Gross written premium for Rescue and other personal lines increased by 5.1% to £421.1 million primarily due to Travel partnerships pricing
- COR increased by 1.0 percentage point to 94.3%
- Operating profit reduced slightly to £43.6 million

Performance highlights

	2017	2016
In-force policies (thousands)		
Rescue	3,591	3,646
Other personal lines	4,148	4,234
Total in-force policies	7,739	7,880
Of which Green Flag direct	802	729
Gross written premium	£421.1m	£400.8m
Loss ratio	65.4%	61.6%
Commission ratio	5.5%	7.2%
Expense ratio	23.4%	24.5%
Combined operating ratio	94.3%	93.3%
Operating profit	£43.6m	£45.9m

Performance

Rescue and other personal lines in-force policies reduced 1.8% to 7.7 million compared with 2016, primarily due to lower partner volumes. Green Flag direct in-force policies increased by 10.0% in the year from 729k to 802k. Gross written premium increased 5.1% compared with 2016, primarily due to price increases in Travel and strong growth in Green Flag direct which increased 11.5% compared with 2016.

The COR for Rescue and other personal lines was 1.0 percentage point higher at 94.3% (2016: 93.3%) primarily due to an increase in the loss ratio as a result of lower prior-year reserve releases in Travel. The commission ratio improved 1.7 percentage points due to lower payments to partners while the expense ratio improved 1.1 percentage points primarily due to improved marketing efficiency for Rescue. The COR for Rescue was 82.8% (2016: 83.4%).

Operating profit of £43.6 million reduced by £2.3 million. Within Rescue and other personal lines, Rescue operating profit was similar to the prior-year at £43.5 million (2016: £42.8 million).

During Q4 2017 the Group agreed to renew its rescue services partnership with RBS/NatWest for a further five years. The Group is currently in discussion with RBS/NatWest regarding its travel partnership, which is subject to a tender.

The Rescue category has positioned itself as the market disruptor and is seeking to challenge the rescue market. Green Flag launched a new advertising campaign in the second half of 2017, highlighting the value of Green Flag policies compared to its main competitors.

Green Flag has a strong focus for 2018 to seek to further enhance customer experience and build in its 2017 NPS performance.

Commercial

Highlights

- Commercial in-force policies grew by 4.9% with Direct Line for Business growth of 8.1%
- Gross written premium increased by 0.3% to £501.5 million. Direct Line for Business gross written premium grew by 11.9% to £122.6 million
- COR reduced by 5.3 percentage points and operating profit increased by £32.2 million, benefitting from lower weather-related claims costs and higher prior-year reserve releases

Performance highlights

	2017	2016
In-force policies (thousands)		
Direct Line for Business	468	433
NIG	240	242
Total in-force policies	708	675
Gross written premium	£501.5m	£499.8m
Loss ratio	49.9%	55.3%
Commission ratio	19.1%	19.5%
Expense ratio	24.4%	23.9%
Combined operating ratio	93.4%	98.7%
Operating profit	£74.0m	£41.8m

Performance

Commercial in-force policies increased 4.9% to 708k compared with 2016 with a particularly strong performance in Direct Line for Business which increased 8.1%. Commercial gross written premium increased by 0.3% to £501.5 million compared to 2016, reflecting strong growth of 11.9% in Direct Line for Business; particularly in landlord and van products. Gross written premium for NIG decreased by 2.9% compared to 2016, as the Group continued to price for risk and improved profitability.

The Commercial COR of 93.4% benefitted from low weather-related claims costs. The COR was 5.3 percentage points lower than 2016, primarily due to higher prior-year reserve releases following favourable development on liability classes and the non-repeat of the Ogden charge of £24.8 million incurred in 2016. The current-year attritional loss ratio was 2.5 percentage points higher in 2017 as the Group continued to set current accident year reserves conservatively. Based on planned volumes for 2018, the Group's current assumption of a normal annual level of claims costs from major weather events is approximately £20 million.

Operating profit of £74.0 million increased £32.2 million primarily due to the loss ratio improvement.

In line with the Group's strategic pillar to 'lead and disrupt', Direct Line for Business made significant strides in its strategy to disrupt the small and micro commercial insurance industry, launching its new direct insurance platform for UK businesses in April 2017. Hair and Beauty was the first product launched and in December this was followed up by Direct Line for Business's Bed & Breakfast proposition. Management aims to have 75% of its targeted trades launched by the end of 2018.

In addition to the direct channel, NIG continued to support commercial insurance brokers by focusing on enabling easier trading. This included using technology to improve trading efficiency through more on-line products, moving to a paperless offering and investing in new systems for more complex business.

Strong performance, strong capital generation

Financial highlights

- Strong growth in direct own brands[1] premiums and in-force policies up 9.3% and 5.3% respectively, driven again by continued Direct Line momentum in Motor
- Operating profit from Ongoing operations of £610.9 million (2016: £403.5 million), primarily due to the non-repeat of the Ogden discount rate change which was reflected in 2016's results. Profit before tax of £539.0 million (2016: 353.0 million)
- Reported expense ratio in line with 2016. Excluding non-cash intangible assets impairments of £56.9 million (2016: £39.3 million), underlying expense ratio improved 0.5 percentage points to 23.5%
- COR from Ongoing operations of 91.8% (2016: 97.7%) reflecting strong Motor and Commercial performance, including from prior-year reserve releases. Adjusted for normal weather, COR towards the lower end of the target range of 93% to 95%
- Final dividend up by 40.2% to 13.6 pence bringing the total ordinary dividends to 20.4 pence (2016: 14.6 pence) and a special dividend of 15.0 pence (2016: 10.0 pence). Total dividends for 2017 of 35.4 pence per share (2016: 24.6 pence)

	2017 £m	2016 £m
Ongoing operations		
In-force policies (thousands)	15,714	15,806
In-force policies – direct own brands[1] (thousands)	6,909	6,563
Gross written premium	3,392.1	3,274.1
Net earned premium	3,135.0	3,000.6
Underwriting profit	256.9	70.1
Instalment and other operating income	179.3	165.3
Investment return	174.7	168.1
Operating profit – Ongoing	610.9	403.5
Run-off	43.8	26.6
Restructuring costs	(11.9)	(39.9)
Operating profit	642.8	390.2
Finance costs	(103.8)	(37.2)
Profit before tax	539.0	353.0
Tax	(105.0)	(74.2)
Profit after tax	434.0	278.8
Of which Ongoing operations[2]	462.9	293.0
Key metrics		
Loss ratio[3]	57.4%	60.9%
Commission ratio[3]	9.1%	11.5%
Expense ratio[3]	25.3%	25.3%
Combined operating ratio[3]	91.8%	97.7%
Adjusted diluted earnings per share[1] (pence)	33.6	21.2
Return on tangible equity[1]	21.7%	14.2%
Investment income yield[1]	2.5%	2.5%
Net investment income yield[1]	2.1%	2.2%
Investment return yield[1]	2.6%	2.6%
Basic earnings per share[1] (pence)	31.8	20.4
Return on equity	16.6%	10.8%
Net asset value per share (pence)	198.9	184.7
Tangible net asset value per share (pence)	164.4	147.4
Dividend per share		
• interim (pence)	6.8	4.9
• final (pence)	13.6	9.7
• total ordinary (pence)	20.4	14.6
• special (pence)	15.0	10.0
• total (pence)	35.4	24.6
Solvency capital ratio[4] – estimated	162%	165%

Notes:
1. See glossary on pages 174 to 176 for definitions and APM in appendix A from page 177 for reconciliation to financial statement line items.
2. Profit after tax for Ongoing operations has been adjusted to exclude the one-off subordinated debt buy back charge of £53.4 million net of tax.
3. A reduction in the ratio represents an improvement as a proportion of net earned premium, while an increase in the ratio represents a deterioration.
4. Estimates based on the Group's Solvency II partial internal model reported after proposed dividends.

Performance

Operating profit – Ongoing operations

	2017 £m	2016 £m
Underwriting profit	256.9	70.1
Instalment and other operating income	179.3	165.3
Investment return	174.7	168.1
Total operating profit	610.9	403.5

Operating profit from Ongoing operations increased to £610.9 million (2016: £403.5 million). The underwriting result (for both current and prior year), instalment and other operating income and investment income were all higher than for 2016, which was impacted by the change to the Ogden discount rate announced in February 2017. Operating profit from Ongoing operations in 2017 included strong growth at improved margins in the Motor business and strong Commercial results, offset by Home, where 2016 benefitted from significant releases from reserves established following the storms of late 2015. Investment return was higher, with investment income stable while strong realised and unrealised gains more than offset the increased cost of hedging.

In-force policies – Ongoing operations (thousands)

At 31 December	2017	2016
Own brands	3,845	3,642
Partnerships	174	231
Motor total	4,019	3,873
Own brands	1,794	1,759
Partnerships	1,454	1,619
Home total	3,248	3,378
Of which Nationwide and Sainsbury's	631	719
Rescue	3,591	3,646
Other personal lines	4,148	4,234
Rescue and other personal lines	7,739	7,880
Of which Green Flag direct	802	729
Direct Line for Business	468	433
NIG	240	242
Commercial	708	675
Total in-force policies	15,714	15,806

Total in-force policies for Ongoing operations during 2017 reduced by 0.6% to 15.7 million (31 December 2016: 15.8 million). The fall primarily related to lower partner volumes in Home and Rescue and other personal lines partially offset by increases in more profitable Motor and Home direct own brands business. Motor in-force policies grew by 3.8% and Commercial by 4.9% across the period. Own brands direct in-force policies in 2017 grew by 5.3% including a 5.6% increase in Motor, 2.0% increase in Home, 10.0% increase in Green Flag direct and a 8.1% increase in Direct Line for Business.

Gross written premium – Ongoing operations

	2017 £m	2016 £m
Own brands	1,590.9	1,428.7
Partnerships	79.5	110.4
Motor total	1,670.4	1,539.1
Own brands	409.7	404.7
Partnerships	389.4	429.7
Home total	799.1	834.4
Of which Nationwide and Sainsbury's	193.8	215.5
Rescue	161.3	163.1
Other personal lines	259.8	237.7
Rescue and other personal lines	421.1	400.8
Of which Green Flag direct	60.9	54.6
Direct Line for Business	122.6	109.6
NIG	378.9	390.2
Commercial	501.5	499.8
Total gross written premium	3,392.1	3,274.1

Gross written premium increased by 3.6% to £3,392.1 million (2016: £3,274.1 million) primarily relating to an increase in Motor and Home own brands and other personal lines partially offset by a reduction in Motor and Home partnerships.

Underwriting profit and COR – Ongoing operations

	2017	2016
Underwriting profit (£m)	256.9	70.1
Loss ratio	57.4%	60.9%
Commission ratio	9.1%	11.5%
Expense ratio	25.3%	25.3%
COR	91.8%	97.7%

The COR for Ongoing operations of 91.8% (2016: 97.7%) improved 5.9 percentage points, primarily as a result of the improvement in the loss and commission ratios. At the start of the year, the Group set its 2017 COR target for Ongoing operations in the range of 93% to 95%. This assumed a normal level of claims from major weather events. On this basis, the Group achieved a normalised COR towards the lower end of the Group's target range. This also includes an intangible asset impairment charge of £56.9 million (2016: £39.3 million).

Loss ratio analysis by division – Ongoing operations

	Notes	Motor	Home	Rescue and other personal lines	Commercial[1]	Total Ongoing
For the year ended 31 December 2017						
Net earned premium (£m)	4	1,470.6	790.5	417.6	456.3	3,135.0
Net insurance claims (£m)	4	896.0	400.5	273.3	227.5	1,797.3
Prior-year reserve releases (£m)	33	275.5	23.7	6.8	86.3	392.3
Major weather events (£m)		n/a	(13.0)	n/a	n/a	(13.0)
Attritional net insurance claims (£m)		1,171.5	411.2	280.1	313.8	2,176.6
Loss ratio – current-year attritional		79.7%	52.0%	67.1%	68.8%	69.4%
Loss ratio – prior-year reserve releases		(18.8%)	(3.0%)	(1.7%)	(18.9%)	(12.4%)
Loss ratio – major weather events – Home[2]		n/a	1.6%	n/a	n/a	0.4%
Loss ratio – reported	4	60.9%	50.6%	65.4%	49.9%	57.4%
Commission ratio	4	2.5%	17.7%	5.5%	19.1%	9.1%
Expense ratio	4	28.5%	21.1%	23.4%	24.4%	25.3%
COR	4	91.9%	89.4%	94.3%	93.4%	91.8%
For the year ended 31 December 2016						
Net earned premium (£m)	4	1,337.1	816.3	394.4	452.8	3,000.6
Net insurance claims (£m)	4	1,001.7	332.0	243.0	250.5	1,827.2
Prior-year reserve releases (£m)	33	123.5	75.9	17.5	49.8	266.7
Major weather events (£m)		n/a	(18.0)	n/a	n/a	(18.0)
Attritional net insurance claims (£m)		1,125.2	389.9	260.5	300.3	2,075.9
Loss ratio – current-year attritional		84.1%	47.8%	66.0%	66.3%	69.2%
Loss ratio – prior-year reserve releases		(9.2%)	(9.3%)	(4.4%)	(11.0%)	(8.9%)
Loss ratio – major weather events – Home[2]		n/a	2.2%	n/a	n/a	0.6%
Loss ratio – reported	4	74.9%	40.7%	61.6%	55.3%	60.9%
Commission ratio	4	3.2%	22.6%	7.2%	19.5%	11.5%
Expense ratio	4	28.2%	21.7%	24.5%	23.9%	25.3%
COR	4	106.3%	85.0%	93.3%	98.7%	97.7%

The loss ratio was 3.5 percentage points lower at 57.4% (2016: 60.9%) and reflects a broadly flat current-year loss ratio and higher prior-year reserve releases. The current year loss ratio was broadly stable, as improvements in Motor were offset by EoW claims in Home. Prior-year reserves releases included a charge in 2016 of £175.1 million due to the impact of the change to the Ogden discount rate announced in February 2017, while 2017 includes a reserve release of £49 million, arising after a detailed case review of the Group's 2016 Ogden provision. Other prior-year releases were lower year on year, albeit large bodily injury claims developed favourably. Home was impacted by higher EoW claims in 2017, whilst 2016 included favourable development from the storms of late 2015.

The decrease in the commission ratio by 2.4 percentage points to 9.1% primarily reflected lower profit share payments to Home partners, as a result of lower prior-year reserve releases, a higher current-year attritional loss ratio and changes to the business mix and partnership arrangements.

The Group's expense ratio remained stable at 25.3%, as efficiency improvements in the cost base offset higher intangible asset impairments and industry levies. Excluding the impairment charge of £56.9 million (2016: £39.3 million), the underlying expense ratio improved by 0.5 percentage points to 23.5% (2016: 24.0%).

The movement in the current-year attritional loss ratio is a key indicator of underlying accident year performance as it excludes prior-year reserve movements and claims from major weather events. The Group's current-year attritional loss ratio is broadly flat at 69.4% in 2017 (2016: 69.2%) with a significant improvement in Motor partially offset by deterioration in other segments.

By division, the COR improved in 2017 in Motor and Commercial, mainly due to higher prior-year reserve releases, as 2016 included a £175.1 million charge for the Ogden discount rate change while 2017 included a £49 million reserve release. The COR deteriorated in Home, primarily due to lower prior-year reserve releases, as 2016 included releases from the 2015 storms; and the impact of higher EoW claims inflation.

Notes:
1. Commercial attritional loss ratio includes weather costs.
2. Home claims for major weather events, including inland and coastal flooding and storms.

Total costs – Ongoing operations

	Notes	2017 £m	2016 £m
Staff costs		409.6	406.5
Other operating expenses		307.2	277.8
Marketing	10	113.7	112.6
Amortisation and impairment of other intangible assets	10	111.0	96.7
Depreciation	10	27.9	30.1
Total costs		969.4	923.7
Operating expenses	10	794.4	759.3
Claims handling expenses	8	175.0	164.4
Total costs		969.4	923.7

Total costs for Ongoing operations increased to £969.4 million (2016: £923.7 million) reflecting additional costs in line with business growth, along with increases in levies of £13 million during the year and higher intangible asset impairments of £56.9 million (2016: £39.3 million). The impairments are in respect of intangible assets capitalised on the balance sheet and primarily relate to IT projects which aim to improve customer experience, support growth and increase the efficiency of the business. Staff and marketing costs remain broadly flat while absorbing business growth. The increase in claims handling expenses is primarily due to the claims handing provision release of £14 million in 2016. Operating expenses includes £12.5 million (2016: £14.2 million) of investment expenses.

The Group's expense ratio remained stable at 25.3% (2016: 25.3%). Excluding the impairment charge the underlying expense ratio improved 0.5 percentage points to 23.5% (2016: 24.0%).

Instalment and other operating income – Ongoing operations

	2017 £m	2016 £m
Instalment income	116.4	107.1
Other operating income:		
Vehicle replacement referral income	16.9	14.1
Revenue from vehicle recovery and repair services	11.3	19.3
Legal services income	11.0	11.2
Other income	23.7	13.6
Other operating income	62.9	58.2
Total instalment and other operating income	179.3	165.3

Instalment and other operating income from Ongoing operations of £179.3 million increased 8.5% (2016: £165.3 million). Instalment income increased by £9.3 million compared to 2016, primarily as a result of higher Motor volumes. Other operating income increased £4.7 million to £62.9 million (2016: £58.2 million).

Vehicle recovery and repair services include post-accident and pay-on-use-recovery and repairs performed on behalf of third party customers. This income decreased due to a change in the basis of allocation. Other income, which includes salvage income and fee income, increased by £10.1 million in the year to £23.7 million (2016: £13.6 million), primarily due to a change in contractual terms for salvage income.

Investment return

	2017 £m	2016 £m
Investment income	167.1	167.9
Hedging to a sterling floating rate basis	(27.0)	(17.1)
Net investment income	140.1	150.8
Net realised and unrealised gains excluding hedging	35.3	20.7
Total investment return	175.4	171.5

Investment yields

	2017	2016
Investment income yield[1]	2.5%	2.5%
Net investment income yield[1]	2.1%	2.2%
Investment return yield[1]	2.6%	2.6%

The Group's investment strategy is to seek to match the duration of its UK liabilities and protect the Group's capital. To avoid over-concentration in the limited credit market the Group invests in US and some global investment-grade credit. The Group uses derivatives to hedge the currency and interest rate risk back to a sterling floating rate basis, and as a result benefits from credit diversification while hedging to a UK interest rate exposure.

Assets under management increased by £128.3 million reflecting lower capital distributions in 2017 as a result of the Ogden discount rate change, strong investment performance and business growth offset by continued reduction in the Group's net liabilities.

The total investment return increased to £175.4 million (2016: £171.5 million) to give a total yield of 2.6% (2016: 2.6%). Whilst investment income has benefitted from an increase in US interest rates, this has been offset by an increase in the cost of hedging to a sterling floating rate, resulting in a hedging cost of £27.0 million. This was more than offset by other realised and unrealised gains, including on the property portfolio.

Investment income remained broadly stable at £167.1 million (2016: £167.9 million) and the investment income yield was in line with management guidance at 2.5% (2016: 2.5%). Investment income net of hedging costs was £140.1 million (2016: £150.8 million) and the investment income yield net of the hedging result was 2.1% (2016: 2.2%).

Note:
1. See glossary on pages 174 to 176 for definitions.

For 2018 the Group expects the net investment yield, after cost of hedging, to be around 2.1%, reflecting the UK's current low interest rate environment. The performance of the Group's property portfolio has been very strong since its commencement in 2012. However, given the current levels of the UK property market, the Group does not expect significant gains on property in 2018. Overall, the Group currently anticipates a total investment return in the region of £150 million in 2018.

Reconciliation of operating profit

	2017 £m	2016 £m
Motor	364.5	149.1
Home	128.8	166.7
Rescue and other personal lines	43.6	45.9
Commercial	74.0	41.8
Operating profit – Ongoing operations	610.9	403.5
Run-off	43.8	26.6
Restructuring costs	(11.9)	(39.9)
Operating profit	642.8	390.2
Finance costs	(103.8)	(37.2)
Profit before tax	539.0	353.0
Tax	(105.0)	(74.2)
Profit after tax	434.0	278.8

Ongoing operations

All divisions were profitable in 2017, with Motor and Commercial reporting significant improvements in operating profit compared to 2016 due mainly to the non-repeat of the Ogden discount rate change. This was partially offset by a decrease in Home, primarily due to lower prior-year reserve releases and the impact of higher EoW claims. Rescue operating profit of £43.5 million (2016: £42.8 million) is included in the Rescue and other personal lines result.

Run-off costs

The Run-off segment generated a profit of £43.8 million in 2017 (2016: £26.6 million). This increase over 2016 was largely due to the non-repeat of the Ogden charge in 2016.

Restructuring costs

Restructuring costs were significantly lower at £11.9 million (2016: £39.9 million), following the exit of a major site in 2016.

Previously the Group has reported that Run-off profits and restructuring costs which are not reported in Ongoing operations will broadly offset each other between 2015 and 2018 inclusively. Up to the end of 2017, the accumulated net result from Run-off and restructuring was a profit of £43 million.

For simplicity of reporting going forward, the Group's reporting will focus on operating profit rather than operating profit from Ongoing operations. Material restructuring activities or other one-off items will be disclosed if they occur.

Finance costs

Finance costs increased significantly to £103.8 million (2016: £37.2 million) due to the one-off cost associated with the buy-back of £250 million nominal value of the Group's subordinated guaranteed dated notes. The price paid included a premium to nominal value of £76.8 million, reflecting the market price of the notes. Taking into account associated costs and the interest rate swaps, the net impact of this buy-back was £66.1 million.

Going forward, the coupon payment for the recently issued Tier 1 notes will be accounted for directly through equity. As a result of the repurchase, reported finance costs are expected to reduce by approximately half.

Taxation

The effective tax rate was 19.5% (2016: 21.0%), which was broadly in line with the standard UK corporation tax rate of 19.25% (2016: 20.0%).

Profit for the year and return on tangible equity

Profit after tax for the year was £434.0 million (2016: £278.8 million) primarily resulting from higher underwriting profit following the change to the Ogden discount rate in 2016 and reduced restructuring costs partially offset by higher finance charges which include a one-off charge of £66.1 million.

RoTE increased to 21.7% predominantly due to an improvement in profit after tax (2016: 14.2%). The profit after tax in 2017 included in the RoTE calculation includes an adjustment to remove the one-off costs in relation to the buy-back of the £250 million subordinated guaranteed dated notes (£66.1 million before tax). See appendix A – APM from page 177.

Following a review of the approach to the Group's Executive Remuneration policy, the Remuneration Committee is proposing that the level of RoTE required for the March 2018 long-term incentive plan awards to vest be increased from the current range of 15.0% to 18.0% to a range of 17.5% to 20.5%, partly reflecting the issue of the Tier 1 notes.

Earnings per share

Basic earnings per share were 31.8 pence (2016: 20.4 pence) reflecting the increase in profit after tax.

Adjusted diluted earnings per share from Ongoing operations were 33.6 pence (2016: 21.2 pence) reflecting the increase in operating profit.

Dividends

The Board is proposing a final dividend of 13.6 pence per share making a total ordinary dividend of 20.4 pence per share (2016: 14.6 pence). This represents 39.7% growth over the 2016 ordinary dividend in line with the increase in interim dividend announced with the H1 results.

In normal circumstances, the Group expects to operate around the middle of its solvency capital ratio risk appetite range of 140% to 180%. As a result of the Group's lower capital requirements in 2017 and the strong financial performance in the year, the Group has declared a special dividend of 15.0 pence per share as an interim dividend, taking the estimated Group solvency capital ratio post-dividends to 162%. The final dividend will be put to shareholders for approval at the AGM on 10 May, and the final dividend and the special dividend are to be paid on 17 May 2018 to shareholders on the register on 6 April 2018. The ex-dividend date will be 5 April 2018.

Cash flow

Net cash generated from operating activities before investment of insurance assets totalled £204.0 million (2016: £35.0 million). This reflected an increase in cash generated from operations to £277.9 million (2016: £117.1 million) and lower taxes paid.

Net cash used in investing activities of £95.3 million (2016: £125.6 million) reduced mainly due to lower purchases of property, plant and equipment assets.

Net cash used in financing activities of £256.9 million (2016: £528.4 million) reduced £271.5 million as a result of lower dividends paid in 2017 and a net cash generation of £19.7 million from Tier 1 and Tier 2 debt restructuring transactions.

Overall, cash and cash equivalents increased by £193.7 million (2016: £208.4 million increase) across the year to £1,304.5 million (31 December 2016: £1,110.8 million).

Net asset value

At 31 December	2017 £m	2016 £m
Net assets	2,715.1	2,521.5
Goodwill and intangible assets	(471.1)	(508.9)
Tangible net assets	2,244.0	2,012.6
Closing number of shares	1,365.1	1,365.1
Net asset value per share (pence)	198.9	184.7
Tangible net asset value per share (pence)	164.4	147.4

The net asset value at 31 December 2017 was £2,715.1 million (31 December 2016: £2,521.5 million) with a tangible net asset value of £2,244.0 million (31 December 2016: £2,012.6 million). The increase since the beginning of the year reflected the 2017 profit offset by dividends paid and a decrease in the available-for-sale ("**AFS**") investments reserve from £92.1 million at 31 December 2016 to £80.2 million at 31 December 2017.

Reserving

The Group makes provision for the full cost of outstanding claims from its general insurance business at the balance sheet date, including for claims estimated to have been incurred but not yet reported at that date and claims handling provision.

The Group considers the class of business, the length of time to notify a claim, the validity of the claim against a policy, and the claim value. Claims reserves could settle across a range of outcomes, and settlement certainty increases over time. However, for bodily injury claims the uncertainty is greater due to the length of time taken to settle these claims. Annuity payments for injured parties also increase this uncertainty.

The Group seeks to adopt a conservative approach to assessing liabilities, as evidenced by the favourable development of historical claims reserves. Reserves are based on management's best estimate ("**MBE**"), which includes a prudence margin that exceeds the internal actuarial best estimate ("**ABE**"). This margin is made in reference to various actuarial scenario assessments and reserve distribution percentiles. It also considers other short and long-term risks not reflected in the actuarial inputs, as well as management's view on the uncertainties in relation to the ABE.

The most common method of settling bodily injury claims is by a lump sum paid to the claimant and, in the cases where this includes an element of indemnity for recurring costs such as loss of earnings or ongoing medical care, settlement calculations have reference to a standardised Ogden annuity factor at a discount rate of minus 0.75% in 2017 (2016: minus 0.75%). This is normally referred to as the Ogden discount rate. Other estimates are also required for case management expenses, loss of pension, court protection fees, alterations to accommodation and transportation fees.

The Lord Chancellor changed the Ogden discount rate from 2.5% to minus 0.75% with effect from 20 March 2017 based on a three year average of yields on index-linked government securities and the rate may be sensitive to future movements in these instruments. The Government is currently planning to review the Ogden discount rate again based on 'low risk' investments rather than 'very low risk' investments, however, there is considerable uncertainty if, when and how a change might be made.

The Group will continue to exercise judgement around the Ogden discount rate used in its reserves allowing for the possibility for it to change in the future. It considers the uncertainties around the legal framework and its implementation risks to the future rate as being significant but broadly balanced and therefore provisions at the current proposed rate of minus 0.75%. An allowance for further movements in the Ogden discount rate is made within the Group's Solvency II balance sheet and capital requirement. However, it should be noted that the Government is considering not only the appropriate level for the rate but also the methodology of how it is applied, so any sensitivity has considerable limitations and uncertainty.

The Group's prior-year reserve releases were £435.4 million (2016: £290.1 million) with good experience in large bodily injury claims being a key contributor. The releases in 2017 include a £49 million Ogden specific release where the claims file review performed in H1 following the Ogden discount rate change indicated a lower ultimate cost at the new rate than was assumed at the year end 2016. In addition, large bodily injury claims developed favourably. Home prior-year reserve releases of £23.7 million (2016: £75.9 million) were affected by EoW experience, whilst in 2016 Home benefitted from favourable development on the December 2015 weather events.

Looking forward, the Group expects to set its initial MBE for future accident years conservatively. Over time, the proportion of the Group's underwriting profit attributable to the current-year is expected to increase, including due to targeted improvements in the expense and commission ratios. Assuming current claims trends continue, the contribution from prior-year reserve releases is expected to remain significant, albeit it is expected to reduce over time.

Claims reserves net of reinsurance

At 31 December	2017 £m	2016 £m
Motor	1,919.7	2,084.2
Home	293.3	298.1
Rescue and other personal lines	85.6	72.8
Commercial	578.3	607.0
Total Ongoing	2,876.9	3,062.1
Run-off	267.6	326.2
Total Group	3,144.5	3,388.3

For details relating to the sensitivity analysis for the potential impact of a change in the discount rate used in relation to periodic payment orders ("**PPOs**") and changes in assumed Ogden discount rate see note 3.3.1 of the consolidated financial statements.

Reinsurance

The objectives of the Group's reinsurance strategy are to reduce the volatility of earnings, facilitate effective capital management, and transfer risk outside the Group's risk appetite. This is achieved by transferring risk exposure through various reinsurance programmes:

- Catastrophe reinsurance to protect against an accumulation of claims arising from a natural peril event. The retained deductible is 13.99% of gross earned premium (c.£150 million) and cover is placed annually on 1 July, up to a modelled one in 200 years loss event of 118.94% of gross earned premium (c.£1,275 million). At the last renewal, 1 July 2017, approximately 60% of the reinsurance programme was placed on a fixed price basis (reinsurers' rate on line) for three years.
- Motor reinsurance to protect against a single or an accumulation of large claims which renews on 1 January. The retained deductible is at an indexed level of £1 million per claim, providing a substantial level of protection against large motor bodily injury claims. This programme was renewed on 1 January 2018 with a partial 90.50% placement on the first layer of reinsurance £2 million excess £1 million. All other layers are placed 100%.
- Commercial property risk reinsurance to protect against large individual claims with a retained deductible of £4 million which renews annually on 1 July.

Taxation

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

The tax policy of the Group is published on the Direct Line Group corporate website in accordance with the requirements of paragraph 16(2) of Sch 19 of the Finance Act 2016. The policy sets out the approach of the Group to managing its tax affairs, to ensure it complies with applicable tax laws and regulations, meets its corporate social responsibilities as a contributor of corporate taxes and as a collector of taxes on behalf of HMRC, manages its tax affairs efficiently, and claims tax reliefs and incentives where appropriate.

Investment portfolio

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

- to ensure there is sufficient liquidity available within the investment portfolio to meet stressed liquidity scenarios determined by the Risk function
- to match PPO and non-PPO liabilities in an optimal manner
- to deliver a suitable risk-adjusted investment return commensurate with the Group's risk appetite

Asset and liability management

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

Liabilities	Assets	Characteristics
More than 10 years, for example PPOs	Property and infrastructure debt	Inflation linked or floating
Short and medium term – all other claims	Investment-grade credit, short-term high yield and subordinated financial debt	Key rate duration matched
Tier 1 equity	Investment-grade credit	Fixed
Tier 2 sub-debt (swapped fixed to floating)	Commercial real estate loans and cash	Floating
Surplus – tangible equity	Investment-grade credit, cash and government debt securities	Fixed or floating

Asset allocation and benchmarks

The current strategic asset benchmarks for the Group are detailed in the following table:

At 31 December	Benchmark holding 2017	Actual holding 2017	Benchmark holding 2016	Actual holding 2016
Investment-grade credit	60.0%	58.1%	58.0%	59.1%
High yield	6.0%	5.8%	6.0%	6.2%
Investment-grade private placements	4.0%	1.5%	4.0%	1.3%
Credit	70.0%	65.4%	68.0%	66.6%
Sovereign	8.0%	3.4%	8.0%	5.2%
Total debt securities	78.0%	68.8%	76.0%	71.8%
Infrastructure debt	5.0%	4.7%	6.0%	5.1%
Commercial real estate loans	3.0%	2.5%	3.0%	1.2%
Cash and cash equivalents	9.0%	19.4%	9.0%	16.9%
Investment property	5.0%	4.6%	6.0%	5.0%
Total	100.0%	100.0%	100.0%	100.0%

Investment holdings and yields – total Group

	2017			2016		
	Allocation (£m)	Income (£m)	Yield (%)	Allocation (£m)	Income (£m)	Yield (%)
Investment-grade credit[1]	3,893.1	109.2	2.8%	3,888.3	104.9	2.6%
High-yield	388.6	19.7	4.9%	409.9	17.8	4.8%
Investment-grade private placements	103.6	2.4	2.6%	85.1	1.4	2.9%
Credit	4,385.3	131.3	3.0%	4,383.3	124.1	2.8%
Securitised credit[2]	–	–	–	–	3.5	2.0%
Sovereign	224.8	6.2	2.2%	341.2	8.9	2.3%
Total debt securities	4,610.1	137.5	3.0%	4,724.5	136.5	2.8%
Infrastructure debt	316.4	6.8	2.1%	337.0	7.8	2.4%
Commercial real estate loans	169.0	3.7	3.0%	79.7	1.0	2.6%
Cash and cash equivalents[3]	1,304.5	2.9	0.2%	1,110.8	4.2	0.4%
Investment property	309.3	16.2	5.1%	329.0	18.4	5.1%
Total Group	6,709.3	167.1	2.5%	6,581.0	167.9	2.5%

At 31 December 2017, total net investment holdings of £6,709.3 million were 1.9% higher than at 31 December 2016, reflecting operating cash flows offset by dividends paid. Total debt securities were £4,610.1 million (31 December 2016: £4,724.5 million), of which 4.8% were rated as 'AAA' and a further 61.9% were rated as 'AA' or 'A'. The average duration at 31 December 2017 of total debt securities was 2.3 years (31 December 2016: 2.3 years). At 31 December 2017, total net unrealised gains, net of tax, on AFS investments were £80.2 million (31 December 2016: £92.1 million).

Notes:
1. Asset allocation at 31 December 2017 includes investment portfolio derivatives, which have been included and have a mark-to-market asset value of £55.1 million included in investment grade credit (31 December 2016: mark-to-market liability value of £5.8 million). This excludes non-investment derivatives that have been used to hedge interest on subordinated debt and operational cash flows.
2. Securitised credit was disposed of during 2016.
3. Net of bank overdrafts: includes cash at bank and in hand and money market funds with no notice period for withdrawal.

Capital management

Capital management policy

The Group aims to manage its capital efficiently and generate long-term sustainable value for shareholders, while balancing operational, regulatory, rating agency and policyholder requirements.

The Group aims to grow its regular dividend in line with business growth.

Where the Board believes that the Group has capital which is expected to be surplus to the Group's requirements for a prolonged period, it would intend to return any surplus to shareholders. In normal circumstances, the Board expects that a solvency capital ratio around the middle of its risk appetite range of 140% to 180% of the Group's SCR would be appropriate and it will therefore take this into account when considering the potential for special distributions.

In the normal course of events the Board will consider whether or not it is appropriate to distribute any surplus capital to shareholders once a year, alongside the full year results.

The Group expects that one-third of the annual dividend will generally be paid in the third quarter as an interim dividend, and two-thirds will be paid as a final dividend in the second quarter of the following year. The Board may revise the dividend policy from time to time. The Company may consider a special dividend and/or a repurchase of its own shares to distribute surplus capital to shareholders.

Solvency II

In its results, the Group has estimated its Solvency II own funds, SCR and solvency capital ratio as at 31 December 2017. The Group will formally submit its final Solvency and Financial Condition Report in May 2018 to the PRA, and expects to continue to update the assumptions and implement minor model changes until then. Therefore, the final solvency position may differ from those included in these results.

Sensitivity analysis

The following table shows the Group's estimated solvency capital ratio sensitivities based on the assessed impact of scenarios as at 31 December 2017.

Scenario	Impact on solvency capital ratio
Motor bodily injury deterioration equivalent to accident years 2008 and 2009	(7pts)
One-off catastrophe loss equivalent to the 1990 storm	(9pts)
One-off catastrophe loss based on extensive flooding of the River Thames	(9pts)
Change in reserving basis for PPOs to use a real discount rate of minus 1%[1]	(13pts)
100bps increase in credit spreads[1,2]	(11pts)
100bps decrease in interest rates[2]	(9pts)

Notes:
1. The methodology for calculating the impact on the ratio of an increase in credit spreads and a change in the reserving basis for PPOs to use a real discount rate of minus 1% have been updated in 2017.
2. The sensitivities only include the assessed impact of the above scenarios in relation to AFS investments.

Capital surplus

The Group's SCR and solvency capital ratio are as follows:

At 31 December	2017	2016
Solvency capital requirement (£bn)	1.39	1.40
Capital surplus above solvency capital requirement (£bn)	0.86	0.91
Solvency capital ratio post-dividend	162%	165%

The following table splits the Group's own funds by tier on a Solvency II basis.

At 31 December	2017 £bn	2016 £bn
Tier 1 capital before foreseeable dividends	1.98	1.87
Foreseeable dividends	(0.39)	(0.13)
Tier 1 capital – unrestricted	1.59	1.74
Tier 1 capital – restricted	0.35	–
Tier 1 capital	1.94	1.74
Tier 2 capital – sub debt	0.26	0.54
Tier 3 capital – deferred tax	0.05	0.03
Total own funds	2.25	2.31

At 31 December 2017, the Group held a Solvency II capital surplus of approximately £0.86 billion above its regulatory capital requirements and was equivalent to an estimated solvency capital ratio of 162%, post-dividend.

Tier 1 capital after foreseeable dividends represents 86% of own funds and 139% of the estimated SCR. Tier 2 capital relates solely to the Group's £0.26 billion subordinated debt. The amount of Tier 2 and Tier 3 capital permitted under the Solvency II regulations is 50% of the Group's SCR and of Tier 3 it is less than 15%. Therefore, the Group has no ineligible capital.

On 7 December 2017, the Group issued £0.35 billion of Tier 1 notes with a coupon of 4.75%. The notes have an optional redemption date of 7 December 2027 and if the notes are not repaid on that date, the rate of interest will be reset. Proceeds of the issuance were primarily used to fund the repurchase of half of the Group's £0.50 billion 9.25% Tier 2 capital. This repurchase of Tier 2 capital was achieved at a value of approximately £0.33 billion including accrued interest. The remaining Tier 2 capital of £0.25 billion nominal value has a redemption date of 27 April 2022.

The Group has issued Tier 1 notes to mitigate the risk of a single refinancing date. In addition, under Solvency II eligibility restrictions the Group previously had limited options to raise additional subordinated debt (Tier 2) capital to recover solvency. As a result of raising the Tier 1 notes and repaying half of the Tier 2 capital the Group has the ability to raise further Tier 2 capital should this be required.

The special dividend will be payable from surplus capital generated from continuing operations of the Group.

Reconciliation of International Financial Reporting Standard ("**IFRS**") shareholders' equity to Solvency II own funds

At 31 December	2017 £bn	2016 £bn
Total shareholders' equity	2.72	2.52
Goodwill and intangible assets	(0.47)	(0.51)
Change in valuation of technical provisions	(0.19)	(0.05)
Other asset and liability adjustments	(0.08)	(0.09)
Foreseeable dividends[1]	(0.39)	(0.13)
Tier 1 capital – unrestricted	1.59	1.74
Tier 1 capital – restricted	0.35	–
Tier 1 capital	1.94	1.74
Tier 2 capital – sub debt	0.26	0.54
Tier 3 capital – deferred tax	0.05	0.03
Total own funds	2.25	2.31

Movement in capital surplus

	2017 £bn	2016 £bn
Capital surplus at 1 January	0.91	0.78
Underlying movement in capital generation	0.49	0.19
Market movements	–	0.12
Capital generation	0.49	0.31
Change in solvency capital requirement	0.01	0.27
Surplus generation	0.50	0.58
Capital expenditure	(0.10)	(0.11)
Management capital action	0.03	–
Capital distribution – ordinary dividends[1]	(0.28)	(0.20)
Capital distribution – special dividends[1]	(0.20)	(0.14)
Net surplus movement	(0.05)	0.13
Capital surplus at 31 December	0.86	0.91

During 2017, the Group's own funds reduced from £2.31 billion to £2.25 billion. The Group generated £0.49 billion of Solvency II capital offset by £0.10 billion of capital expenditure and capital distribution of £0.48 billion, including the 2017 interim and final ordinary dividends and special interim dividends. The capital management action refers to the debt refinancing activity mentioned above.

Leverage

The Group's financial leverage continued to be conservative at 18.4% (2016: 17.6%). While the Tier 1 notes issued during 2017 are presented as equity in the balance sheet, the Group considers this to be part of its total leverage and the £346.5 million (net of arrangement costs) is included in the ratio.

At 31 December	2017 £m	2016 £m
Shareholders' equity	2,715.1	2,521.5
Tier 1 notes	346.5	–
Financial debt – sub debt	264.7	539.6
Total capital employed	3,326.3	3,061.1
Financial leverage ratio[2]	18.4%	17.6%

Credit ratings

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

Regulatory update

Throughout 2017, the FCA's focus has been on value measures and pricing practices as well as the publication of its business plan. The PRA focus has been on the pillars of its financial risk framework, namely reserving, pricing, reinsurance and investments. The Group is exposed to the risk of changes to regulatory rules, policy or interpretation, and to supervisory expectations or approach by regulators or other bodies or authorities; and of changes to law, tax, monetary or fiscal policies or their interpretation by government or government authorities, any of which may have adverse operational and financial impact.

The Group will continue to support proportionate reforms which result in a level playing field across the industry.

Outlook

For 2018 and over the medium term, the Group targets achieving a 93% to 95% COR assuming a normal annual level of claims from major weather events and no further change to the Ogden discount rate, supported by reductions in its expense and commission ratios; and reiterates its ongoing target of achieving at least a 15% RoTE.

For 2018, the Group targets net investment income yield to be around 2.1%, with overall investment return in the region of £150 million.

Statement of the Directors in respect of the Strategic report

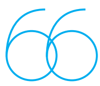
The Board reviewed and approved the Strategic report on pages 1 to 43 on 26 February 2018.

By order of the Board
Paul Geddes
Chief Executive Officer
26 February 2018

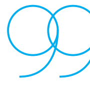
John Reizenstein
Chief Financial Officer
26 February 2018

Notes:
1. Foreseeable dividends included above are adjusted to exclude the expected dividends waivers in relation to shares held by the employee share trusts, which are held to meet obligations arising on the various share option awards.
2. Total IFRS financial debt as a percentage of total IFRS capital employed.

Corporate Governance



The Board recognises the importance of succession planning and understands the need to have leaders who live the Group's culture and values.



Dear shareholders and other stakeholders,

On behalf of the Board, I am pleased to present the Corporate Governance report for the year ended 31 December 2017. The Board continues to focus on maintaining high standards of corporate governance, which we seek to achieve through the Group's robust governance framework.

Our commitment to good corporate governance

The Corporate Governance report sets out the Direct Line Group framework, which we believe enables effective decision-making and management of the risks in the markets in which we operate. Matters Reserved to the Board and the role of the Board's Committees are core elements of this framework. The Corporate Governance and Committee reports highlight the areas of focus, challenge and supervision for the Board and its Committees during 2017.

Succession planning and Board changes

Succession planning has been an area of focus for the Board in 2017. The Board recognises the importance of succession planning and understands the need to have leaders who live the Group's culture and values. Board diversity from various perspectives is also considered an important matter by the Board and its Nomination Committee. The Board has female representation of 36% and the Board remains committed to seeking to improve further its position on diversity when appropriate opportunities arise.

Following a review of the Board's expertise and experience, the Nomination Committee engaged external consultants in the search for new candidates. The Nomination Committee led the selection and appointment of Danuta Gray as a Non-Executive Director, with effect from 1 February 2017, and Mike Holliday-Williams was appointed as an Executive Director also on 1 February 2017. On 1 November 2017, Penny James joined the Board as an Executive Director and Chief Financial Officer-designate. The appointment coincided with the announcement that John Reizenstein would be retiring from the Board following the AGM on 10 May 2018. Penny will take over as CFO on 1 March 2018. She joined us from Prudential plc, where she served as Chief Risk Officer and a Group Board member. You can find further information on our diversity policy, our approach to succession planning and Board appointments on pages 70 and 71.

Effectiveness and evaluation

As Chairman, my principal objective is to develop and lead an effective Board for the benefit of our shareholders. The Board undertakes a review of its effectiveness each year and appoints an external evaluator every third year, as recommended by the UK Corporate Governance Code. Having benefitted from an external review in 2016, the Board and its Committees carried out their 2017 effectiveness review in-house with the assistance of the Company Secretary. Respondents agreed that strengths identified in earlier reviews, including the Board's culture, the openness of its debate and the quality of information received, remained strengths. In the interests of continuous improvement, some suggestions for fine-tuning were raised during the review process and taken into consideration by the Board. You can find further details on page 53.

Executive remuneration

The debate in the UK over executive remuneration remains a valid topic for discussion and continuous evaluation. The Group's remuneration policy was approved by shareholders at the AGM in 2017 and is expected to remain in place for three years. Further details on the work of the Remuneration Committee can be found on page 72 and the remuneration policy summary is detailed on pages 94 to 99.

UK Corporate Governance Code

The Board is committed to the principles of the UK Corporate Governance Code 2016 issued by the Financial Reporting Council (the "Code"). I am pleased to report that we have complied with all of the principles of the Code. You can find further explanation and details on pages 49 to 58.

Culture and values

The Board is responsible for securing the long-term success of the Group. The Board aims to deliver this success by creating an open and collaborative culture that encourages the Group to make decisions that are best for our shareholders, whilst having regard for our other stakeholders. I believe that the values and the Code of Business Conduct set by the Board are central to the Group's culture. Our Code of Business Conduct governs the way we treat our stakeholders and our values determine our behaviours. Together, these elements reflect the way we do business with the objectives of delivering long-term sustainable shareholder value and of ensuring our Group's long-term success. You can find further information on how the values and the Code of Business Conduct aim to deliver long-term success whilst having regard to the interests of our stakeholders on page 59.

Our shareholders

Communication with shareholders is extremely important to us. By maintaining dialogue with you, we aim to ensure that your views are considered and our objectives are understood. I would like to thank you for your support and look forward to discussing the Group's progress with you at our forthcoming AGM on 10 May 2018.

Yours sincerely

Michael N Biggs
Chairman

Our values

Do the right thing

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

Aim higher

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

Work together

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

Take ownership

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

Say it like it is

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

Bring all of yourself to work

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

Our Code of Business Conduct

Your Board maintains strong relationships and regular interaction with our shareholders. Their continued support for our strategic aims is important.

See page 60 for our full Code of Business Conduct. See page 57 for relations with shareholders.

Board of Directors

Mike Biggs,
Chairman of the Board

Appointed
April 2012

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

Mike was previously Chairman of Resolution, then a FTSE 100 UK life assurance business, and has acted as Chief Executive Officer and Group Finance Director of Resolution plc. He was previously Group Finance Director of Aviva plc. He is an Associate of the Institute of Chartered Accountants in England and Wales.

Current external appointments
Mike is Chairman of Close Brothers Group plc.

Paul Geddes,
Chief Executive Officer

Appointed
August 2009

Biography
Paul is Chief Executive Officer ("CEO"). He has been CEO since 2009 and led the Group through its financial turnaround, separation from RBS Group, initial public offering ("IPO") and its entry into the FTSE 100. Under his leadership, the Group has delivered value for its customers and returns for shareholders by maintaining strong financial performance and underwriting discipline. This has been achieved with a clear strategy, by investing in the engagement of Direct Line people, embedding a values-driven culture and a focus on making insurance much easier and better value for customers.

After joining RBS Group in 2004 as Managing Director responsible for products and marketing, he became the CEO of RBS Group's mainland UK retail banking business. Before joining RBS Group, Paul held various senior multi-channel retailing roles in the GUS and Kingfisher groups. Paul started his career in marketing, with UK and European roles at Procter & Gamble.

Current external appointments
Paul is the Deputy Chairman of the Association of British Insurers ("ABI") Board and a Non-Executive Director of Channel Four Television Corporation.

Danuta Gray,
Independent NED

Appointed
February 2017

Biography
Danuta was Chairman of Telefónica O2 in Ireland until December 2012, having previously been its Chief Executive from 2001 to 2010. During her nine year tenure as Chief Executive, she increased the customer base from just under 1 million to over 1.7 million. Prior to Telefónica O2, Danuta held various senior positions within BT Group from 1984 to 2001.

Current external appointments
Danuta is interim Chairman of Aldermore Group plc, a Non-Executive Director and Chairman of the Remuneration Committee of PageGroup plc, a Non-Executive Director and Chairman of the Remuneration Committee of Old Mutual plc, and a Non-Executive Member of the Defence Board of the UK Ministry of Defence.

Jane Hanson,
Independent NED

Appointed
December 2011

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

She spent her early career with KPMG, working in the financial sector, later becoming responsible for delivering corporate governance, internal audit and risk-management services in the north of England. Jane has also held a number of executive roles, including Director of Audit, and Risk and Governance Director at Aviva's UK Life business. She is a Fellow of the Institute of Chartered Accountants in England and Wales.

Current external appointments
Jane is Chair of Reclaim Fund Ltd and an Independent Member of the Fairness Committee at ReAssure Ltd. She has her own financial sector consulting business and is also a magistrate.

Mike Holliday-Williams,
Managing Director, Personal Lines

Appointed
February 2017

Biography
Mike is Managing Director, Personal Lines. He joined Direct Line in 2014 and has over 10 years' insurance industry experience. Under his leadership, the Personal Lines division has delivered strong growth, improved profitability and strengthened its competitive position. This has been achieved through a strong focus on our customers, by enhancing our proposition across our brands and channels, and improving our capability in trading, pricing and digital.

Mike was previously CEO of RSA Group's Scandinavian businesses, Codan A/S and Trygg-Hansa, and before that UK Managing Director of Personal Lines at RSA, responsible for the MORETH>N, Partnerships and the Broker businesses. Before joining RSA, Mike had many general management, marketing and customer growth roles across several industries including the energy, telecoms and retail sectors.

Current external appointments
Mike is a member of the ABI General Insurance Council.

Penny James,
Chief Financial Officer-designate

Appointed
November 2017

Biography
Penny joined the Board as Chief Financial Officer-designate on 1 November 2017 and will succeed John Reizenstein as Chief Financial Officer ("CFO") on 1 March 2018. Penny has extensive financial services experience, having been Group Chief Risk Officer and Executive Director at Prudential plc, where she was responsible for leading risk oversight globally. Before this she was Director of Group Finance at Prudential. She had previously been Group Chief Financial Officer at Omega Insurance Holdings Limited and CFO, UK General Insurance, at Zurich Financial Services. Penny was a Non-Executive Director of Admiral Group plc from January 2015 to September 2017. Penny is an Associate of the Institute of Chartered Accountants in England and Wales.

Current external appointments
None.

Sebastian James,
Independent NED

Appointed
August 2014

Biography
Sebastian is Chair of the Corporate Social Responsibility ("CSR") Committee. He has extensive experience in retail and consumer practice at large groups; and has a detailed understanding of the UK consumer markets, products and brands. Sebastian was previously CEO of Synergy Insurance Services Limited and subsequently gained wide retail experience as Strategy Director responsible for developing and implementing the turnaround strategy at Mothercare.

Current external appointments
Sebastian is Group Chief Executive of Dixons Carphone plc and is also a trustee of the charities, Save the Children and The DSG International Foundation.

Andrew Palmer,
Independent NED

Appointed
March 2011

Biography
Andrew is Chair of the Audit and Investment Committees. He has performed various senior roles in the financial services and insurance industries. Additionally, he has insight into corporate governance developments and best practice in financial reporting. In 2009, Andrew retired from Legal & General Group plc, where he was the Group Finance Director. He is a Fellow of the Institute of Chartered Accountants in England and Wales.

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

John Reizenstein,
Chief Financial Officer

Appointed
December 2010

Biography
John was CFO throughout 2017 and will be succeeded by Penny James on 1 March 2018. He joined the Group in 2010 as CFO and led the IPO in 2012. Under John's financial stewardship, the Group has achieved and upgraded its financial targets, sold its International division at an attractive price, and undertaken multiple actions to return capital to shareholders. He has also been focused on the sustainability of the Group's strong financial track record through targeted reductions in the Group's expense and commission ratios, as well as actions to underpin the Group's planned loss ratio.

John has extensive City and financial services experience, spending more than 20 years in investment banking with UBS and Goldman Sachs. He was previously an Executive Director at the Co-operative Insurance Society, CIS General Insurance and The Co-operative Bank. He was CFO of these organisations between 2003 and 2007, and subsequently Managing Director, Corporate and Markets.

Current external appointments
John is a Trustee and Director of Farm Africa. He has been appointed to the Panel on Takeovers and Mergers (the "Panel") with effect from 1 May 2018, having been an alternate representative of the ABI on the Panel since 2015.

Clare Thompson,
Independent NED

Appointed
September 2012

Biography
Clare is Chair of the Remuneration Committee. She has extensive experience and knowledge of people and remuneration gained from her roles at PwC. These included People Partner for Assurance which focused on talent management and career development planning, as well as involvement in the design and operation of remuneration structures across PwC UK. She also has significant financial and audit experience.

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

Current external appointments
Clare is a Non-Executive Director of British United Provident Association ("Bupa") and Retail Charity Bonds plc. She is also a Non-Executive member of the partnership board of Miller Insurance Services LLP, and Treasurer of the Disasters Emergency Committee.

Dr Richard Ward,
Independent NED and SID

Appointed
January 2016

Biography
Dr Richard Ward is Senior Independent Director ("SID"). Richard was Chief Executive of Lloyd's of London, from 2006 to 2013. He was a Non-Executive Director of Partnership Assurance Group plc, now part of Just Group plc, between 2013 and 2016 and was Chairman of the Remuneration Committee from 2014 to 2016. Richard previously worked for over 10 years at the London-based International Petroleum Exchange, the second largest energy trading exchange, re-branded ICE Futures, as both CEO and Vice-Chairman. He has extensive insurance industry experience and insight into prudential regulation.

Prior to the International Petroleum Exchange, Richard held a range of senior positions at British Petroleum and was Head of Marketing & Business Development for energy derivatives worldwide at Tradition Financial Services.

Current external appointments
Richard is Executive Chairman of Cunningham Lindsey and Non-Executive Chairman of Brit Syndicates Ltd. He also serves as a member of the PRA Practitioner Panel, Bank of England.

Key for Committee membership

- Audit Committee
- Board Risk Committee
- CSR Committee
- Investment Committee
- Nomination Committee
- Remuneration Committee

Executive Committee

Paul Geddes chairs the Executive Committee. In addition to Paul Geddes, Mike Holliday-Williams, Penny James and John Reizenstein, the Committee comprises the following:

Jonathan Greenwood,
Managing Director, Commercial

Joined
2000

Experience and qualifications
Jonathan is Managing Director, Commercial. He joined the Group in 2000 and has over 30 years' experience of the insurance industry. Jonathan is responsible for delivering the Commercial strategy, developing customer propositions, enhancing the Commercial brands and delivering efficiencies within the Commercial businesses.

Under Jonathan's leadership, the Commercial division has returned to profit, delivered strong growth within Direct Line for Business, improved its pricing capabilities and strengthened NIG's competitive position. He has also delivered enhanced customer propositions and improved digital capabilities.

Jonathan was previously Managing Director of the Group's household and life businesses. He joined the Group as Product and Pricing Director for UK Partnerships. Before joining the Group, Jonathan held roles at HBOS, MBNA and Pinnacle.

Steve Maddock,
Chief Operating Officer

Joined
2010

Experience and qualifications
Steve is Chief Operating Officer. He joined Direct Line Group in 2010 and has nearly 30 years' experience of the insurance industry. Steve is responsible for leading the Group's Claims, Information Technology ("**IT**"), Information Security, Procurement and Business Services functions.

Under Steve's leadership, the Group has realised significant benefits and efficiencies through delivering the claims transformation programme, rationalising the Group's property footprint, enhancing the procurement and contract management processes, and implementing the IT transformation programmes.

Steve's previous roles include Director of Strategic and Technical Claims at RSA, Director of Claims and Customer Service at Capita, and Director of Operations at AMP. Steve is also Chairman of the Motor Insurers' Bureau.

Simon Linares,
Group Human Resources Director

Joined
2014

Experience and qualifications
Simon is Group Human Resources Director. He joined the Group in 2014 and is responsible for leading the Group's HR function, Internal & External Communications and Public Affairs. He is also responsible for delivering the Group's People and CSR strategies. Simon is a Fellow of the Chartered Institute of Personnel and Development.

Under Simon's leadership, the Group has achieved significant improvements in employee engagement, people development, succession planning and diversity & inclusion. Simon's achievements include the Group becoming a signatory to the Women in Finance Charter, and the successful implementation of the Group's Graduate and Apprenticeship schemes.

Simon has spent the majority of his career as a leader in customer-centric businesses. Before moving into HR, Simon held several commercial business roles in the fast-moving consumer goods and financial services sectors. Simon is also a trustee of the KidsOut UK charity.

Humphrey Tomlinson,
General Counsel

Joined
2011

Experience and qualifications
Humphrey is General Counsel. He joined the Group in 2011 and has over 25 years' experience as a solicitor. Humphrey is responsible for the Group Legal function and oversees a range of areas of legal advice and services.

During Humphrey's leadership of the Group Legal function and its team of lawyers, he has overseen the legal aspects of the Group's £500 million debt issue, the IPO and the related separation of the Group from RBS Group, the sale of the Group's International division, and the 2017 £350 million Restricted Tier 1 debt issue. He is also a Director of DLG Legal Services Limited.

Humphrey's experience includes advising on corporate and commercial matters, steering corporate transactions in the UK and internationally, managing legal risk and dealing with corporate governance issues. Before joining the Group, Humphrey was Group Legal Director at RSA and prior to that he was a corporate lawyer with the City law firm, Ashurst Morris Crisp. He is a graduate of the University of Oxford.

José Vazquez,
Chief Risk Officer

Joined
2012

Experience and qualifications
José is Chief Risk Officer. He joined the Group in 2012 and has over 25 years' experience of the insurance industry. José is responsible for the Group's Risk Management and Compliance function and is a Fellow of the Institute of Actuaries.

During José's leadership of the Risk and Compliance function, the Group has achieved separation from RBS Group, delivered its IPO and sold its International division. José successfully led the programme to implement Solvency II and to design, build and obtain approval from the PRA for the Group's Internal Model. Under his stewardship, the Group's approach to risk management has developed and matured. This has been achieved by enhancing and embedding greater ownership of risk management in the business and driving improvements in risk behaviours and attitudes across the Group.

José was previously Global Chief Risk Officer and Group Chief Actuary at HSBC Insurance. Before joining HSBC, José worked for Zurich Insurance, first in its London Market Operations, then as Chief Actuary International Business Division (Asia, Latin America and Africa) and lastly as Chief Actuary in the UK.

Key for Committee membership

CSR Committee

This report explains the Board's role and activities, and how corporate governance operates throughout the Group.

The UK Corporate Governance Code

Direct Line Insurance Group plc (the "Company") has complied with all of the principles and, except as explained below, all provisions of the Code throughout the financial year up to the date of this report.

The only exception is the recommendation contained in Provision E.1.1 of the Code that the SID should attend sufficient meetings with major shareholders to listen to their views. Throughout 2017, the Board received regular updates from the Company's corporate brokers on the views of its institutional shareholders and, in addition, the Investor Relations team provided regular updates to the Board. The Chairman, CEO and CFO met with key shareholders following announcements of results and reported shareholders' views back to the Board. On this basis the Board is satisfied that it understands the views of shareholders, and major shareholders have been invited to meet with the SID should they wish to do so.

It is open to all shareholders to raise any issues they wish with the Chairman, the SID and the Chair of the Remuneration Committee. The Board has therefore concluded that it has complied with the main and supporting principles under section E.1 of the Code regarding dialogue with shareholders.

Further details of how the Company applied the Code's principles and complied with its provisions can be found on the following pages of this report and the Directors' remuneration report:

- Leadership – page 49
- Effectiveness – page 52
- Accountability – page 56
- Remuneration – page 57
- Relations with shareholders – page 57

For more information about the Code, visit the Financial Reporting Council's website at www.frc.org.uk.

Leadership

The Board

The Board has a collective objective of promoting the long-term success of the Company for its shareholders and provides leadership of the Company.

The Board's specific duties are set out in the Schedule of Matters Reserved for the Board, which contains items reserved for the Board to consider and approve, relating to strategy and management, contracts, financial reporting and controls, internal controls and risk management, Board membership and succession planning, corporate governance, structure and capital, delegation of authority and remuneration.

In addition to the schedule of Matters Reserved, each Board Committee has written terms of reference defining its role and responsibilities. Further details regarding the role and activities of the Board and Board Committees can be found on pages 50 and 61 to 73.

Board composition

As at the date of this report, the Board comprised the Chairman, who was independent when appointed to the Board; four Executive Directors; and six independent NEDs, including the SID. The current Directors served throughout all of 2017, except for Danuta Gray and Mike Holliday-Williams who were appointed on 1 February 2017 and Penny James who was appointed on 1 November 2017.

Biographical details of current Directors of the Company as at the date of this report are set out on pages 46 and 47.

Meetings

The Board and Board Committees held a number of scheduled meetings in 2017 at which senior executives, external advisers and independent advisers were invited to attend and present on business developments and governance matters. The Company Secretary attended all Board meetings and he or his nominated deputy attended all Board Committee meetings. The table below sets out attendance at the scheduled meetings[1] in 2017. Additional Board and Committee meetings were convened during the year to discuss ad hoc business development, governance and regulatory matters.

	Board	Audit Committee	Board Risk Committee	CSR Committee	Investment Committee	Nomination Committee	Remuneration Committee
Chairman							
Mike Biggs	9 of 9	–	–	–	–	3 of 3	3 of 3
Senior Independent Director							
Richard Ward	9 of 9	–	5 of 5	–	–	3 of 3	–
Non-Executive Directors							
Danuta Gray[2]	7 of 8	–	–	–	–	1 of 1	2 of 2
Jane Hanson	9 of 9	5 of 5	5 of 5	3 of 3	4 of 4	–	–
Sebastian James	9 of 9	–	–	3 of 3	–	–	3 of 3
Andrew Palmer	9 of 9	5 of 5	5 of 5	–	4 of 4	3 of 3	3 of 3
Clare Thompson	9 of 9	5 of 5	–	–	–	–	3 of 3
Executive Directors							
Paul Geddes	9 of 9	–	–	3 of 3	–	–	–
Penny James	2 of 2	–	–	–	–	–	–
Mike Holliday-Williams	8 of 8	–	–	–	–	–	–
John Reizenstein	9 of 9	–	–	–	1 of 1	–	–
Executive Committee member							
Simon Linares	–	–	–	3 of 3	–	–	–

Notes:
1. Attendance is expressed as the number of scheduled meetings attended out of the number of such meetings possible or applicable for the Director to attend.
2. Due to external business commitments arranged prior to Danuta Gray's appointment, she was unable to attend the June 2017 Board meeting.

Structure of the Board, Board Committees and executive management

The diagrams on pages 50 and 51 summarise the role of the Board, its Committees and the responsibilities of the Chairman, the CEO and executive management. The Board and Board Committees have unrestricted access to management and external advisers to help discharge their responsibilities. The Board and Board Committees are satisfied that, in 2017, sufficient, reliable and timely information was received to perform their responsibilities effectively. Each Committee plays a vital role in helping the Board to operate efficiently and consider matters appropriately.

Board

Leadership

The Board has clear divisions of responsibility and seeks the long-term success of the Group.

Shareholder benefit

The Board organises and directs the Group's affairs in a way that it believes will help the Group succeed for the benefit of shareholders as a whole.

More information on the Board's approach towards the Group's wider stakeholders' interests can be found on page 59.

Operations

The Board supervises the Group's operations, with a view to ensuring they are effectively managed, that effective controls are in place, and that risks are assessed and managed appropriately.

Strategy

The Board sets the Group's strategy, and monitors management's performance and progress against the strategic aims and objectives.

Culture

The Board develops and promotes the collective vision of the Group's purpose, culture, values and behaviours.

Information & Support

The Board accesses assistance and advice from the Company Secretary. The Board may seek external independent professional advice at the Company's expense, if required, to discharge its duties.

Board Committees

The Audit Committee:

- Monitors the integrity of the Group's financial statements
- Oversees and challenges the effectiveness of the Group's systems of financial and other controls
- Monitors the work and effectiveness of the Group's internal and external auditors and actuaries
- Meets privately with the External Auditor and Group Head of Audit in the absence of management
- The chair of the Audit Committee has regular one-to-one meetings with the CFO

The Board Risk Committee:

- Oversees and advises the Board on the Group's current and potential future risk exposures, and its strategic approach to managing risk
- Recommends risk appetite and tolerance levels to the Board and supports the Board in promoting a risk-aware culture across the Group
- Meets privately with the CRO without the presence of management
- The chair of the BRC has monthly one-to-one meetings with the CRO

The CSR Committee:

- Provides oversight and advice on how the Group conducts its business responsibly, including matters relating to environmental, employee engagement and wellbeing, community involvement, ethics and diversity

The Investment Committee:

- Provides oversight of the Group's investment strategy
- Oversees the management and performance of the Group's investment portfolio

The Nomination Committee:

- Reviews the Board's structure, size, composition, and balance of skills, experience, independence, expertise and knowledge of the Company
- Leads the process for Board appointments and makes recommendations to the Board
- Provides guidance to management on executive succession planning

The Remuneration Committee:

- Sets and oversees how the Group implements its remuneration policy
- Oversees the level and structure of remuneration arrangements for senior executives, approves share incentive plans, and recommends them to the Board and shareholders
- Interacts with the Audit Committee and BRC when considering setting targets and pay-outs
- Engages its independent adviser, FIT Remuneration Consultants LLP ("FIT") on market practice, corporate governance, incentive plan design and target-setting, regulations and other remuneration matters when necessary

Board and executive management roles

Each Director brings different skills, experience and knowledge to the Company, with the NEDs bringing additional independent thought and judgement.

The Chairman:

- Maintains, develops and leads the Board
- Plans and manages the Board's business
- Ensures the Directors receive accurate, timely and clear information
- Presides at Board meetings
- The Board has agreed individual role profiles for the Chairman and the CEO. These clearly define their roles and responsibilities and ensure that no one person has unlimited powers of decision-making.

The SID:

- Acts as a sounding board for the Chairman and an intermediary for the other Directors when necessary
- Available to shareholders if they have any concerns they cannot resolve through normal channels
- Leads the Chairman's performance evaluation annually

The NEDs:

- Challenge management in an objective and constructive manner
- Use their wider business experience to help develop the Group's strategy
- Depending on the needs of the business, the NEDs and the Chairman commit at least three days a month and three days a week respectively to discharging their duties effectively as contained in their letters of appointment. The letters are available for inspection at the Company's registered office and AGM.

The CEO

As authorised by the Board, the CEO manages the Group's day-to-day operations and delivers its strategy and financial results. The CEO delegates certain elements of his authority to Executive Committee members to help ensure that senior executives are accountable and responsible for managing their businesses and functions.

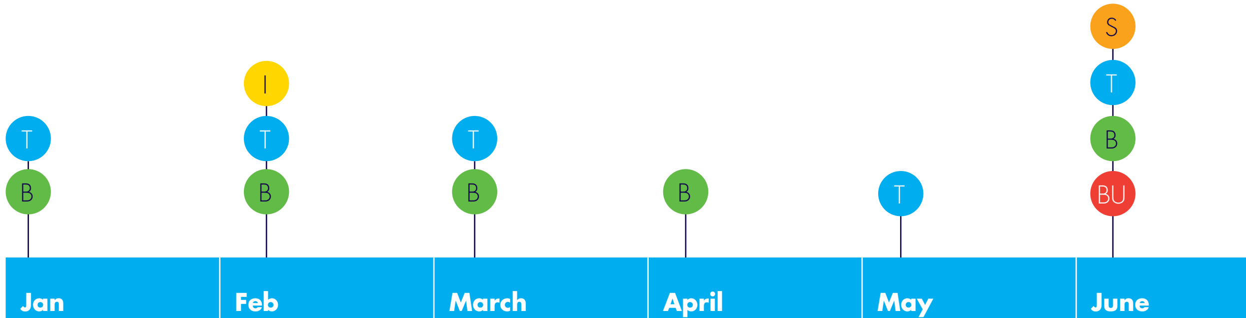
The Executive Committee

The Executive Committee is the principal management committee that helps the CEO manage the Group's operations. It helps him:

- Set performance targets
- Implement the Board-determined Group strategy and direction
- Monitor key objectives and commercial plans to help achieve the Group's targets
- Evaluate new business initiatives and opportunities

Biographical details of the Executive Directors and Executive Committee members are shown on pages 46 to 48.

Effectiveness
Board meetings & activity in 2017



Board meetings

The activities undertaken by the Board in 2017 intended to promote the success of the Company, are focused on its role as the leadership and decision-making forum for the Group.

Scheduled Board meeting discussions (set out on the timeline above) focused on four main themes in 2017:

Strategy & execution, including: setting the Group's key strategic targets and monitoring the Group's performance against those targets; reviewing customer experience and monitoring the Group performance against external brand metrics; reviewing and approving key projects aimed at developing the business or rationalising costs; reviewing the approach to mergers and acquisitions; and reviewing the individual strategy of key business lines.

Financial performance and investor relations, including: setting financial plans, annual budgets and key performance indicators ("KPIs"), and monitoring the Group's results against them; considering the Group's reserving position; approving financial results for publication; resetting the Group's dividend policy; approval of catastrophe reinsurance arrangements; motor reinsurance renewal; authorising the Group's planned capital management exercise of issuing of £350 million Fixed Rate Reset Perpetual Restricted Tier 1 notes with a coupon of 4.75% ("Tier 1 notes") to investors, which were primarily used to fund the repurchase of half the Group's £500 million (nominal) 9.25% Tier 2 debt; and reviewing broker reports on the Group alongside feedback from investor meetings.

Risk management, regulatory and other related governance, including: considering the impact of the Ogden discount rate review on the Group; reviewing and agreeing the Group's Policies; setting risk appetites; approving the ORSA; approving major changes to the Group's partial internal model and seeking to ensure that the Group complies with all regulatory requirements.

Board & Board Committee governance, including: receiving reports from the Board's Committees; updating terms of reference for the Committees; and implementing an annual review of the Board and Board Committees' effectiveness.

The co-ordination of the Board meeting content is managed by the Chairman, and supported by the CEO and Company Secretary.

In addition to routine business, the Board considers and discusses key issues that impact on the business as they arise. The CEO and CFO spend a considerable amount of time with the different business units ensuring that the Board's aims are being correctly disseminated throughout the Group, and that colleagues' views and opinions are reported back to the Board. The NEDs meet with key management outside the Board and Committee fora to get a wider view of the Group's activities.

Strategy day

The Board sets aside time each year outside the annual Board calendar to hold a strategy day giving the Directors the opportunity to focus solely on strategic matters. In June 2017, the Board held a session offsite to set and monitor progress against the Group's strategy and to discuss the strategic challenges and opportunities the Group faces in the future, including advances in car technology.

Board training

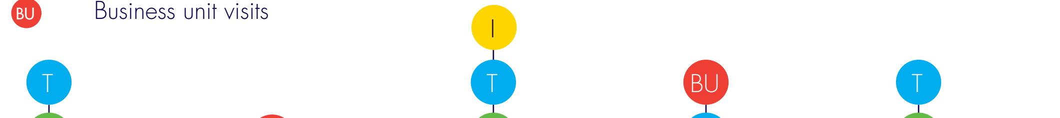
The Board is committed to the training and development of Directors and employees. The Company Secretary is responsible for helping the Chairman regularly review and organise training for the Directors. The Company Secretary also maintains an annual training agenda for the Board and its Committees. In order for our Directors, particularly the NEDs, to discharge their responsibilities, it is essential that they understand our business.

The main Board training activities in 2017 included training on topics such as:

- competition law;
- Solvency II matters;
- the Group's Internal Economic Capital Model ("IECM");
- the Group's investment risk appetite;
- cyber risk and security;
- the upcoming new insurance contracts standard (IFRS 17);
- the outlook for internal audit in 2020;
- EU General Data Protection Regulation ("EUGDPR");
- alternative pricing;
- conduct pricing; and
- motor reinsurance.

Key for Board meetings & activity in 2017

- B Board meetings
- S Strategy day
- T Training
- I Induction
- BU Business unit visits



Business unit visits

The Board visits different business units during the year. During 2017, NED visits to operational business units were arranged to meet the management teams and better understand how the business operates. These included visits to Sales, Customer Operations, Auto Services, Digital, Personal Lines, Data Science, Operational Risk and Commercial teams in Ipswich, Glasgow, Warwick, Doncaster and Bromley.

Board inductions

All new Directors appointed to the Board undertake an induction programme aimed at ensuring they develop an understanding and awareness of our businesses, people and processes, and of their roles and responsibilities as Directors of the Company. The programmes are tailored to suit each Director and include:

- provision of relevant current and historical information about the Company and the Group;
- visits to operations around the Group;
- induction briefings from Group functions; and
- one-to-one meetings with Board members, senior management and the Company's advisers.

Danuta Gray's programme focused on the Group's businesses, strategic and transformational priorities, regulatory and governance frameworks, capital and financial management, and risk framework. Given Mike Holliday-Williams' extensive experience of the business, his induction programme focused on his duties and responsibilities as an Executive Director of the Company and corporate governance matters.

Penny James commenced her induction programme in September 2017 which prepared her for her role as an Executive Director and CFO of the Company. The programme was tailored to familiarise Penny with the business, its culture, the market in which it operates and its people.

Board and Committee effectiveness review

In accordance with the principles and provisions of the Code, the Board's intended practice is to conduct a thorough review of the effectiveness of the performance of the Directors, the Board as a whole and its Committees on an annual basis, with the input of an external facilitator at least once every three years.

The 2016 Board effectiveness review was facilitated by an external consultant, Professor Rob Goffee of London Business School, who is independent and has no other connection with the Company. In 2017, the Board chose to conduct its effectiveness review in-house.

The Company Secretary designed and co-ordinated the process. This involved agreeing a structured questionnaire with the Chairman, SID and the Chairs of the Board's Committees, distributing it to and interviewing the directors and stakeholders and preparing reports. The Board and each of its Committees reviewed and discussed the relevant reports.

Building on positive responses to the 2016 effectiveness review, the 2017 questionnaire focused on further opportunities for improvement, including making the best use of the experience and expertise of NEDs in the Board's strategic thinking, the preservation of the Board's culture at a time of changes to its composition and how the supportive and challenging relationship between the Board and the Group's senior management can be preserved and enhanced.

The Committee questionnaire focused on the clarity of each Committee's role and scope, its composition, the resources available to it and the effectiveness of communicating the Committee's proceedings to stakeholders.

Outcome of the effectiveness review

The Chairman discussed the outcome of the effectiveness review with the NEDs and the CEO, providing them with feedback on their individual performance and contributions. The Board and each of its Committees received and debated their own reports resulting from this exercise. Feedback on the Chairman's performance was provided by the SID, with input from his fellow NEDs.

Based on the responses to the questionnaire and resulting reports, the Directors are satisfied that the Board and each of its Committees operated effectively in 2017. The Directors are also satisfied that they made significant progress in areas identified for potential improvement in 2016.

Whilst the findings of the 2017 effectiveness review were positive, the Board and each of its Committees will focus during 2018 on opportunities for fine-tuning with the objective of further improving effectiveness.

Governance framework and structure

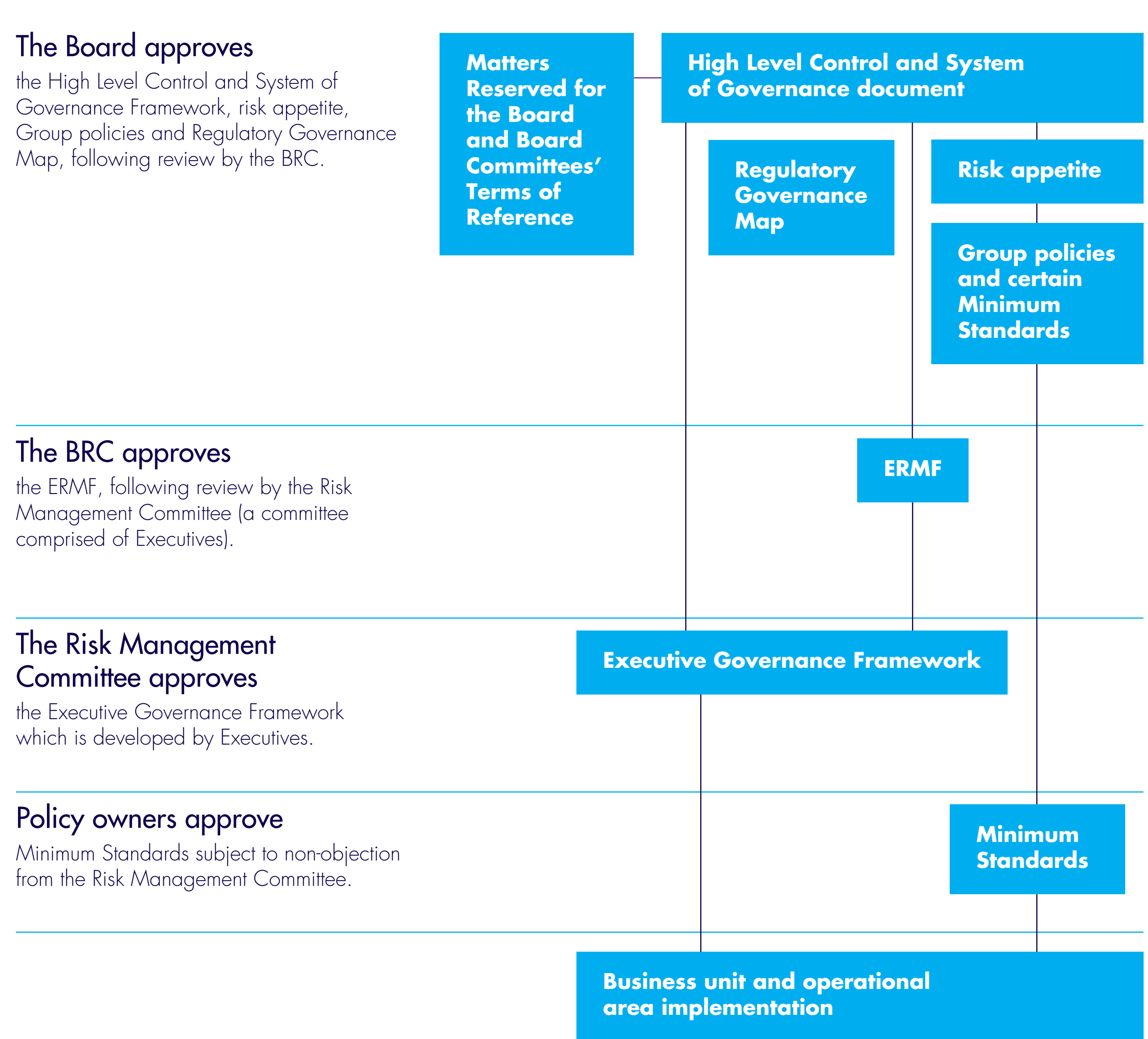
The Board is responsible for ensuring an appropriate system of governance is in operation throughout the Group. This includes a robust system of internal controls and a sound risk management framework. The Board has established a risk management model that separates the Group's risk management responsibilities into three lines of defence. An explanation of these responsibilities can be found on page 22.

The Group's governance framework is detailed in the Group's High Level Control and System of Governance Framework document. This document, together with the Regulatory Governance Map, details how the Group meets Solvency II and PRA requirements to identify Key Functions, to have and maintain a Governance Map and the requirements in respect of the PRA Senior Insurance Managers Regime and the FCA Approved Persons regime. The Board reviews these documents annually.

The core elements of the Governance Framework are the:

- Matters Reserved for the Board and the Board Committees' Terms of Reference;
- High Level Control and System of Governance Framework document;
- Regulatory Governance Map;
- risk appetite statements, which are described on page 22;
- Enterprise Risk Management Strategy and Framework ("ERMF"), which is described on page 23;
- Executive Governance Framework, which outlines how each business function is governed and details the authority delegated to Executive Committee members;
- Group policies, which address specific risk areas and inform the business how it needs to conduct its activities to remain within Risk Appetite; and
- Minimum Standards, which interpret the Group policies into a set of operational requirements that can be implemented throughout the Group.

The diagram below summarises the split of responsibilities for the different parts of the Group's governance framework.



Conflicts of interest

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

Each Director has a duty to avoid conflicts of interest. They must declare any conflict of interest that could interfere with their ability to act in the Group's best interests.

The Board has authorised certain potential conflicts of interest in this way. However, the Board still deals with any actual conflict of interest or duty that might arise. This usually would involve making sure a Director does not participate in a relevant Board or Committee discussion or decision.

To do this, the Company Secretary maintains a register of conflicts, and any conflicts that the Board has authorised.

The Board reviews this register at each scheduled Board meeting.

Approach to diversity

The Board and Executive management are committed to ensuring that diversity is promoted across all areas of the Group and that everyone is treated fairly irrespective of their racial or ethnic origin, gender, age, disability, belief or sexual orientation, religion, or educational or professional background. There is a Board approved diversity policy and progress has been made in embedding principles and practices to promote diversity across the Group and to champion the benefits of a diverse and inclusive workforce.

The principles and practices set by the Board and the progress made in broadening the diversity of the Board include:

1. Maintaining at least 30% female representation on the Board

The Board is committed to seeking to maintain at least 30% female representation and at the same time to ensure that diversity as a whole remains a central feature. However the Board will continue to appoint the most appropriate candidates based on knowledge, skills, experience and, where necessary, independence.

The Board appointed two female Directors during 2017 (Danuta Gray and Penny James). As at 26 February 2018, being the date of this report, Board female representation was 36%. The Board's female representation exceeds the target set in Lord Davies' Women on Boards Review Five Year Summary to be achieved by 2020 and remains on target with the Hampton-Alexander Review's recommendations for a minimum of 33% of women's representation on boards by 2020.

2. Only engaging executive search firms who have signed up to the Voluntary Code of Conduct for Executive Search Firms on gender diversity and best practice.

In its search for candidates, the Board aims to only engage with executive search firms who are signatories to the Voluntary Code of Conduct for Executive Search Firms. During the year, the Nomination Committee worked closely with Egon Zehnder and Heidrick and Struggles, which culminated in the appointment of Danuta Gray and Penny James respectively. Both of these executive search firms are signatories to the Voluntary Code and neither has any other connection with the Company.

Further information regarding the Group's approach to diversity including the process for Board appointments and reappointments can be found on pages 70 and 71 of the Nomination Committee report.

Senior management gender diversity

The Board remains committed to ensuring that high-performing women from within the business and from a variety of backgrounds, who have the requisite skills, are given the opportunity to progress their career internally.

The Group is a signatory to the Women in Finance Charter which aspires to see gender balance at all levels across financial services firms. The Group is committed to seeking to increase female representation at senior management level to 30% by the end of 2019. As at 31 December 2017, women represented 25% of the Group's senior management. The charts on page 28 of the CSR report provide a clearer picture of the diversity of the Board, senior managers and employees.

During the year, the Group introduced new initiatives, including succession planning programmes, to broaden and strengthen female talent at middle management level. Other key 2017 gender diversity initiatives included: the promotion of flexible working; a partnership with the EveryWoman network which helps organisations enhance the potential of female talent; and mentoring schemes and associated development programmes for high-potential female candidates.

Additional 2017 diversity initiatives

Other initiatives to broaden the diversity of the Board and senior management were also undertaken during 2017 and included: the revitalisation of the Diversity Network Alliance disability strand and the addition of the neuro-diversity strand; the creation of an inclusive work environment programme; the introduction of unconscious bias training for people managers; and the Group's sponsorship of multiple diversity events.

Nomination Committee

On behalf of the Board, the Nomination Committee assesses the NEDs' independence, skills, knowledge and experience as part of its annual review of each Director's performance. The Board concluded that every current NED was independent, continued to contribute effectively, and demonstrated they were committed to the role. The Board is also satisfied that the Chairman's external appointment as Chairman of Close Brothers Group plc set out on page 46 does not restrict him from carrying out his duties effectively.

Jane Hanson, Mike Biggs and Clare Thompson have served on the Board since December 2011, April 2012 and September 2012 respectively. At the Board's request, they have agreed to continue serving as NEDs and resolutions for their re-election as Directors will be proposed to the 2018 AGM. In accordance with the Code, the extension of their terms of appointment beyond six years has been the subject of a particularly rigorous review. The Board is satisfied that Jane, Mike and Clare continue to make a significant contribution to the proceedings of the Board and its Committees and that the extension of their terms of appointment will provide valuable continuity as work on refreshing the Board progresses.

The Nomination Committee's work during the year led to the appointment of Danuta Gray as an additional NED, Mike Holliday-Williams, MD Personal Lines, as an Executive Director, both with effect from 1 February 2017 and Penny James as an Executive Director with effect from 1 November 2017. You can find out more about these activities and the Nomination Committee's work during the year on pages 70 to 71.

Accountability

An explanation of how the Board complies with the Code in relation to accountability is set out below, except for the following matters, which are covered elsewhere in the Annual Report & Accounts:

- how the Company seeks to generate value over the long term is explained in the business model on pages 6 and 7, and the strategy for delivering Company objectives is on pages 14 to 19; and
- how the Board has assessed the Group's longer-term viability and the adoption of the going concern basis in the financial statements is on pages 23 and 103.

The Board has delegated responsibility to the Audit Committee to oversee the management of the relationship with the Company's External Auditor. You can find details of the Audit Committee's role, activities and relationship with the External Auditor in the Committee report on pages 61 to 64.

Responsibility for preparing the Annual Report & Accounts

The Board's objective is to give shareholders a fair, balanced and understandable assessment of the Company's position and prospects and business model and strategy. The Board is also responsible for maintaining adequate accounting records and seeks to ensure compliance with statutory and regulatory obligations.

You can find an explanation from the Directors about their responsibility for preparing the financial statements in the Statement of Directors' responsibilities on page 103. The Company's External Auditor explains its responsibilities on page 111.

The Directors confirm that they consider that the Annual Report & Accounts, taken as a whole, are fair, balanced and understandable, and provide the information that shareholders and stakeholders need to assess the Group's position and performance, business model and strategy. In arriving at this conclusion, the Board was supported by a number of processes, including the following:

- management drafted the Annual Report & Accounts to ensure consistency across sections, and a steering group comprising a team of cross-functional senior management provided overall governance and co-ordination;
- a verification process, to ensure the content was factually accurate;
- members of the Executive Committee reviewed drafts of the Annual Report & Accounts;
- the Company's Disclosure Committee reviewed an advanced draft of the Annual Report & Accounts; and
- the Audit Committee reviewed the substantially final draft of the Annual Report & Accounts, before consideration by the Board.

Risk management and internal control systems

The Board oversees the Group's risk management and internal control systems. It has complied with the Code by establishing a continuous process for identifying, evaluating and managing the principal risks the Group faces.

The Board has established a management structure with defined lines of responsibility and clear delegation of authority. This control framework cascades through the divisions and central functions, detailing clear responsibilities to ensure the Group's operations have appropriate controls. This includes controls relating to the financial reporting process.

The frameworks for risk management and internal control were in place for the financial year under review and up to the date of this report. They are regularly reviewed by the Board and comply with the Financial Reporting Council's updated guidance on Risk Management, Internal Controls and Related Financial and Business Reporting.

The Group operates a Three Lines of Defence model. You can find out more about this in the Risk management section on page 22.

The Board, with the assistance of the BRC and the Audit Committee as appropriate, monitored the Company's risk management and internal control systems that have been in place throughout the year under review, and reviewed their effectiveness. The monitoring and review covered all material controls, including financial, operational and compliance controls. The Board and its Committees are overseeing the programme of activity to upgrade and better integrate the major IT systems within the Group's technology infrastructure, including focusing on developing future capability for both customers and colleagues and monitoring risks relating to IT systems' stability, cyber security and the internal control environment.

The Board was also supported in its review of the annual Control Environment Certification process. As part of this, each directorate self-assessed its risks and whether its key controls were appropriate and effective. The Risk and Group Audit functions reviewed and challenged these findings. The Group then combined the overall findings into a Group-level assessment, which the CEO approved. The process included reporting on the nature and effectiveness of the controls, and other management processes that manage these risks.

The BRC regularly reviews significant risks and how they might affect the Group's financial position; comparisons to agreed risk appetites; and what the Group does to manage risks outside its appetite.

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

The Directors acknowledge that any internal control system can manage, but not eliminate, the risk of not achieving business objectives. It can only provide reasonable, not absolute, assurance against material misstatement or financial loss.

On behalf of the Board, the Audit Committee regularly reviews the effectiveness of the Group's internal control systems. Its monitoring covers all material controls. Principally, it reviews and challenges reports from management, the Group Audit function and the External Auditor. This enables it to consider how to manage or mitigate risk in line with the Group's risk strategy.

Assessing principal risks

The Board determines the nature and extent of the risks that it is willing to take to achieve its strategic objectives. The Directors robustly assessed the principal risks facing the Company, including risks that would threaten its business model, future performance, solvency or liquidity. You can find a description of these risks, and their management or mitigation, on pages 24 and 25.

This confirmation is based on the BRC's twice-yearly review and challenge of the Group's Material Risk Assessment ("MRA"), and the Board's review and approval of the Group's risk appetite statements. The MRA identifies risks quantified as having a residual risk impact of £40 million or more based on a 1-in-200 years likelihood. The quantifications are produced through stress and scenario analysis, and the IECM. Each directorate's bottom-up risk identification and assessment supplements the MRA. The MRA also plays a key role in developing the ORSA and assessing the Group's strategic plan.

Remuneration

The Board has delegated responsibility to the Remuneration Committee for the remuneration arrangements of the Group's Executive Directors and Chairman. It recommends and monitors the remuneration level and structure for senior executives. You can find out more about this in the Directors' remuneration report starting on page 74.

Relations with shareholders

The Board believes that engaging regularly with the Company's shareholders is vital to the Group's success. Communicating and engaging with investors means the Board can express clearly its strategy and performance and receive regular feedback from investors. It also gives the Company the opportunity to respond to questions and suggestions.

During 2017, the Board received regular updates from the Executive Directors, the Investor Relations team and the Company's corporate brokers on the views of its shareholders and other investors.

The Chairman, SID and NEDs are available to attend meetings with major shareholders at their request. During 2017, the Company's major shareholders were offered the opportunity to meet with the Chairman and/or the SID. In 2017, the Chairman met some of the Company's major shareholders and discussed corporate governance topics including the Board's philosophy on shareholder returns with respect to regular and special dividends.

It is open to all shareholders to raise any issues they wish with the Chair of the Remuneration Committee. As part of the development of the revised remuneration policy for Executive Directors which was approved by shareholders at the Group's 2017 AGM, the Chair of the Remuneration Committee led a wide-ranging consultation through engagement with proxy advisers, regulators and shareholders on matters relating to executive remuneration.

During 2017, the CEO and the CFO met with key shareholders following announcements of results and reported shareholders' views back to the Board. They discussed a range of matters including the Group's growth, Home and Motor strategies, price comparison website competitiveness, profitability, IT investment and reserving policy.

The Investor Relations team helps the Directors to communicate with investors. As demonstrated in the calendar on the next page, the Directors, in conjunction with senior management and the Investor Relations team, participated in varied forms of engagement, including investor meetings, seminars and conferences throughout 2017.

The CEO and CFO hosted conference calls for the Group's quarterly results briefings and presentations for its 2016 full year results in March 2017 and its 2017 half year results in August 2017. In addition, the CEO and CFO provided a short video summarising the key messages of the Group's 2016 full year results which is available on the Company's website.

During 2017, the brokers undertook a comprehensive collection of investor views of the Group. The feedback received from the brokers helped the Group in its aim to provide investors with a simpler and more succinct summary of progress to date and the medium term direction of the business, from a financial, operational and strategic perspective.

Taking feedback received from the brokers into account, the Board also reviewed the Company's dividend policy. The revised policy which was disclosed in the 2017 Half Year Report, aims to maintain flexibility and guide investors in their understanding of how the Group approaches the consideration of special dividend payments in the future. Further details on the revised dividend policy can be found on pages 42 and 100.

We communicate with our debt investors through regular announcements and the debt investor section of our website which contains bond information, credit ratings and materials relating to the Group's year-end reports, and information about our long-term debt maturity profile so investors can see the related future refinancing needs of the Group.

The Directors, in conjunction with senior management and the Investor Relations team, met with debt investors in the course of the Group's normal investor conferences and roadshows throughout 2017.

During 2017, the CFO and the Investor Relations team held calls with credit rating agencies on a quarterly basis with each published set of results and an annual review meeting in December.

In December 2017, the Group announced the successful completion of its planned capital management exercises of the issue of Tier 1 notes to investors, which were primarily used to fund the repurchase of half the Group's £500 million 9.25% Tier 2 debt. The principal purposes of the transaction were to increase Tier 2 debt capacity and to spread the maturity profile of the Company's debt. Debt investor feedback received was positive, with strong support for the transaction rationale, investment case, strength of the balance sheet and overall business performance of the Company.

Annual General Meeting

The Board sees the Company's AGM as a good opportunity for private shareholders to talk directly with the Board. All shareholders can attend the AGM if they wish. All Directors attended the AGM in 2017.

At the AGM, the CEO presents the Group's financial results. The Chairman then invites shareholders to ask questions about the meeting's business, before proposing the AGM's formal business. All Directors who wish to continue to serve will be put forward for election or re-election at the AGM. The Chairman, the Committee Chairs and the remaining Directors and members of the Executive Committee are also available to talk with shareholders at the end of the meeting.

The outcome of the resolutions put to the AGM, including poll results detailing votes for, against and withheld, are published on the London Stock Exchange's and the Company's websites once the AGM has concluded.

Q1 2017

- Full Year 2016 results roadshow – London/Edinburgh/USA
- Barclays Global Financials conference – New York
- Morgan Stanley European financials conference – London

Q2 2017

- Q1 Trading Update
- AGM
- Keefe, Bruyette & Woods European financials conference – London
- Goldman Sachs European Financials conference – Madrid
- Investor Relations roadshow – Amsterdam and Copenhagen

Q3 2017

- Half Year 2017 results roadshow – London/Edinburgh/USA
- Barclays Disruptive Mobility conference – London
- Barclays Global Financials conference – New York
- Bank of America Merrill Lynch annual CEO conference – London
- Analyst day – DLG Auto Services, Welwyn Garden City

Q4 2017

- Q3 Trading Update
- UBS European conference – London
- Autonomous Future of Motor Insurance conference
- Tier 1 notes issue roadshow – London/Edinburgh

Having regard to the interests of our stakeholders

The Directors have regard to the interests of the Company's stakeholders with a view to promoting the success of the Group for the benefit of its shareholders as a whole, and pursuing initiatives for the benefit of wider stakeholders. This resonates with the Group's open and collaborative culture and corporate values.

Accordingly the Board has regard to matters including: the consequences of its decisions for the long term; the interests of the Company's employees; the need to foster the Company's business relationships with suppliers, customers and others; the impact of the Company's operations on the community and the environment; and the requirement to act fairly as between members of the Company.

The diagram below sets out some examples of activities undertaken by the Board and its Committees during the 2017 financial year to illustrate how the Board's decisions are informed by an understanding of, and have regard to, the interests and views of its shareholders and other stakeholders.

Understanding our stakeholders

Making insurance much easier and better value for our customers

- The Board has regularly reviewed the strategy, plans and progress of the multi-year transformation programmes to upgrade the Group's operating systems for Personal Lines and Commercial customers aimed at improving customer experience and covering pricing and other related data and digital systems across all products.
- During 2017 the Non-Executive Directors collaborated with Customer Assurance and Operations teams to understand the impact of recent training programmes on customer telephone calls and how this links to creating industry leading conversations and a better experience for the Group's customers.
- The Board listened to telephone calls between customers and employees and reviewed customer feedback to gain a deeper insight into matters including customer retention, complaints handling, overcoming price related problems and the use of telematics.
- The Remuneration Committee has incorporated customer metrics into its decision making process for the award of bonuses to management as part of the Group's AIP.

Investing in our people

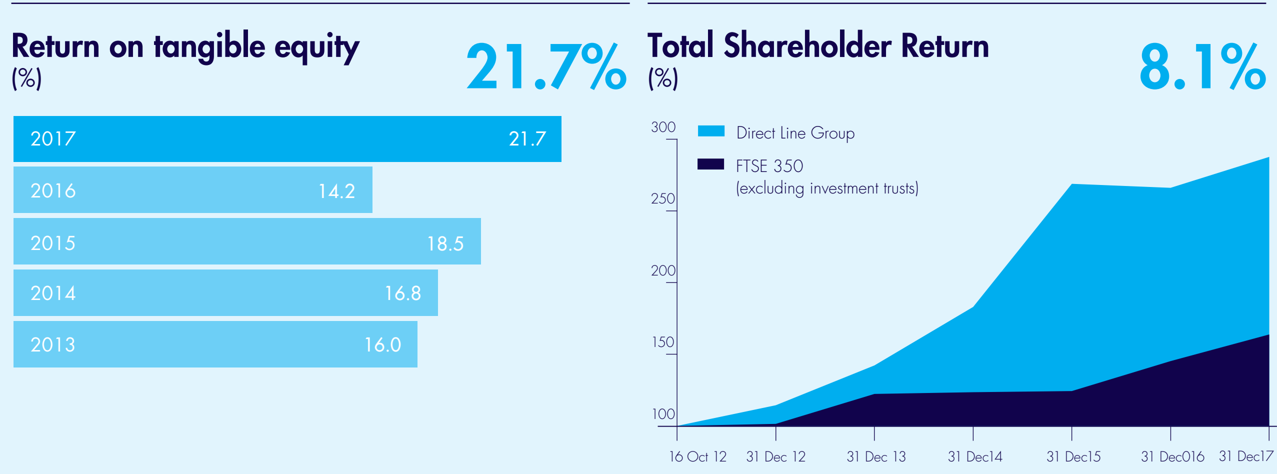
- The Non-Executive Directors visited various office locations and participated in CONNECT activities. CONNECT is a development programme aimed primarily at supporting employees in having better customer conversations.
- As part of a Board visit to the Group's call centre in Doncaster, the Board awarded recognition prizes to employees for creating great customer experience and presented employees with accreditations from the Institute of Customer Service.
- A Leadership conference for circa 650 people managers was held in November 2017, which was attended by members of the Board and all members of the Executive Committee.
- The Group is a signatory to the Women in Finance Charter and the Board is committed to seeking to increase female representation in senior management to 30% by the end of 2019. As at 31 December 2017, female representation in the Group's senior management was 25%.
- The Remuneration Committee has incorporated people metrics into its decision making process for the award of bonuses to management as part of the Group's AIP.

Doing the right thing for the community and the environment

- The Directors have encouraged and supported management with Shotgun, which is the CSR campaign with the ambitious long term aim to reduce deaths of young people in their first 1,000 miles of driving to zero.
- As part of a Board visit to Doncaster, management presented to the Board on how the Doncaster office had delivered against the Group's CSR strategy, with a particular focus on the work undertaken in the local community and raising money for charities.
- In December 2017, the CSR Committee approved a new CSR strategy which has two overarching goals: 'Protecting Britain's road users' and 'Reflecting an ever-changing Britain'. The priority for each goal is Shotgun and diversity and inclusion respectively.
- The CSR Committee believes in the positive benefits from employee participation in fundraising and volunteering and has monitored and challenged progress against CSR KPIs including those relating to energy use, CO_2 emissions and waste. Further details are included in the CSR report on page 29 and are available at www.directlinegroup.com.

Delivering returns for our shareholders

- The Group's investment case is detailed on page 2 and incorporates the medium-term financial targets announced in the Company's 2017 Half Year report relating to: a COR of 93% to 95%; RoTE above 15%; growing the dividend in line with business growth; and maintaining solvency capital around the middle of the 140% to 180% Solvency II target range.
- The Group's dividend policy states the expectation that one-third of the annual dividend will generally be paid in the third quarter as an interim dividend and two-thirds will be paid as a final dividend in the second quarter of the following year. The Group aims to grow its regular dividend in line with business growth. In the normal course of events the Board will consider whether or not it is appropriate to distribute any surplus capital to shareholders once a year, alongside the full year results. Further details on the dividend policy are contained in the Directors' report on page 100.
- For the five years after the IPO the Group has consistently achieved profitable growth and returned £2.4 billion to shareholders, including the £393 million after payment of the proposed final and special dividends. The diagram below sets out the returns relating to RoTE and TSR for the financial years from 2013 to 2017.



Our Code of Business Conduct

The Board has approved a Code of Business Conduct which summarises the Group's business practices in relation to customers, shareholders and other stakeholders, employees, suppliers, the community and environment, competitors and regulators.

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

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

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

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

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

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

Dealing with competitors
We will compete fairly and honestly and in accordance with all applicable competition laws.

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

Andrew Palmer
Chair of the Audit Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

Areas of focus in the reporting period

- The Committee reviews and monitors the reserving process. The Committee challenged the key reserving assumptions and judgements, emerging trends, movements and analysis of uncertainties underlying the ABE and MBE of technical provisions.
- On 27 February 2017 the MoJ announced a change in the personal injury discount rate used in the assessment of damages for large bodily injury claims. The rate changed from 2.50% to minus 0.75%. The Committee reviewed and challenged management's assessment of the impact of the proposed new discount rate on both the cost of settling reported claims and claims incurred but not reported. The associated second order impacts on claims cost, such as the additional cost for claims settling as PPOs and associated reinsurance recoveries were also reviewed. The Committee agreed that the Group should recognise the best estimate net impact of the rate change immediately and therefore the impact was reflected in the 2016 IFRS financial statements and Solvency II surplus capital reported position. Further information can be found in the Annual Report & Accounts for 2016.
- The Committee provides oversight of the accounting estimates and judgements used in the preparation of the financial statements. For further details please see the table of significant judgements and issues on page 62.
- In relation to Group Audit, the Committee received a report on compliance with the updated Chartered Institute of Internal Auditors guidance on effective internal audit in the financial services sector ("**IA Code**"). This provided an opportunity to challenge how the function sought to comply fully with the IA Code.

Committee skills and experience

In line with the Code, the Audit Committee as a whole is deemed to have competence relevant to the insurance and financial services sectors in which the Group operates.

All Committee members are members of the Institute of Chartered Accountants in England and Wales. They also have recent and relevant financial experience across a number of different insurance businesses, enabling them to contribute diverse expertise to the Committee's proceedings. To keep their skills current and relevant, and in addition to Board training, members of the Committee have received training during the period on matters including a deep dive of Group Audit, IFRS 17 and the Solvency II technical provisions.

Main activities during the year

At each scheduled Committee meeting, the Committee receives reports on financial reporting, reserves, internal controls and Group Audit, except at the December 2017 meeting where the focus was on pre year-end financial matters. You can find out more about this in the following sections.

Financial reporting

The Committee monitors the integrity of the financial statements of the Group and any other formal announcement relating to its financial performance. The Group's financial reporting and control framework has been expanded to include Solvency II-related information.

During the year, the Committee reviewed the preliminary announcement of the Group's 2016 financial results, the 2016 Annual Report & Accounts, the 2017 Half Year Report, the Regular Supervisory Report and the Solvency and Financial Condition Report. The Committee then recommended them to the Board for approval. The Committee also reviewed the trading updates for the first and third quarters of 2017.

The Committee followed a review process before recommending the reports to the Board which focused on significant accounting policies and practices, emphasising those requiring a major element of judgement. The review also considered the going concern assumptions and viability statement in the case of the Annual Report & Accounts, valuation of assets and impairment reviews, reserving provisions, unusual transactions, clarity of disclosures and significant audit adjustments. This included the Solvency II balance sheet and the annual Quantitative Reporting Templates.

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

When considering the Annual Report & Accounts for 2017, the Committee focused on the significant judgements and issues which could be material to the financial statements. These included the matters set out in the table on the next page.

Matter considered	Description	Action
Personal injury discount rate	When the Lord Chancellor announced the change to the personal injury discount rate (the "**Ogden discount rate**" or "**ODR**") in February 2017, reducing it from 2.50% to minus 0.75%, the Committee considered the impact on the 2016 accounts and discussed and challenged the analysis. Furthermore, at the time of the Half Year results in 2017, the Committee also considered the proposed release of reserves of £49 million in connection with reduced sensitivity to the Ogden discount rate from reserve releases in the first half of the year.	It is expected that the Ogden discount rate will change more frequently in future and the Committee will monitor the processes for the implementation of a change.
Insurance reserves valuation	The Committee reviewed the ABE of the level of reserves. This included a report from independent external actuarial consultants on their assessment of the appropriate level of reserves for certain risks. Following the review of the ABE, the Committee also considered the MBE of reserves which can take into account certain trends, risks and higher confidence levels than those which are allowed for in the ABE due to its reliance on past experience. Further information on reserves is provided in this report.	The Committee reviews and challenges the ABE and MBE on a six-monthly basis. In addition, it monitors developing trends in risks that could impact the reserves in a positive or negative way. On an ongoing basis deep dives are carried out on different risks.
Valuation of investments not held at fair value	The Committee considered reports on the judgements applied to the carrying value of the Group's investments that are not held at fair value and the basis for the valuation. These assets are principally comprised of infrastructure loans, commercial real estate loans and private placement bonds held within the investment portfolio and information was provided to the Committee on a regular basis to support the value recognised in the accounts. During the year an impairment loss was recognised on the portfolio of £9.5 million and the Committee considered the explanation presented to support the impairment.	The Committee will monitor the carrying value of investments and the basis for that valuation.
Estimates and judgements	The Committee considered the accounting estimates and judgements that had a material impact on the IFRS financial statements. As part of this process, the Committee considered the valuation of intangible assets. These mainly related to investment in the Group's IT systems and capabilities in respect of projects which are aimed at improving the digital offering, customer experience and operational efficiency. Reports were presented to the Committee covering the assumptions and judgements made in coming to a valuation of these assets. As a result, the Committee recommended that an impairment charge of £56.9 million was made in the year.	The Committee continues to consider major accounting estimates and judgements made in preparing the financial statements.

The Committee considered reports prepared by management on the significant estimates and judgements that were material to the financial statements and challenged the judgements being made, in particular in relation to the non-cash intangible asset impairment of £56.9 million. This relates to capitalised software development costs for ongoing IT projects primarily relating to the development of new systems. The Committee also discussed these matters with the External Auditor.

IFRS 17, which relates to recognition, measurement, presentation and disclosure of insurance contracts, applies to annual reporting periods beginning on or after 1 January 2021. It is expected to have a significant impact on accounting for insurance contracts and the Committee received a training session dedicated to the key aspects of IFRS 17 and the likely areas of impact on the Group.

Reserves

Twice a year, the Committee reviews and challenges the key assumptions and judgements, emerging trends, movements and analysis of uncertainties underlying the ABE of technical provisions. At the same time, the Committee considers and challenges the appropriateness of the CFO's proposals for MBE of reserves. These are informed by actuarial analysis, wider commercial and risk management insights, and principles of consistency from period to period. After reviewing the ABE and MBE of reserves, the Committee recommends them to the Board.

The Committee approves the annual plan for reviews of reserves, informed by emerging internal and external issues. At the other two scheduled meetings, the Committee considers developing trends in reserving and discusses and challenges the underlying assumptions that are used in setting the ABE reserves.

It also considers an appropriate balance between internal and external actuarial review. Consultants appointed to provide actuarial reviews of reserves are subject to approval by the Committee. An external actuarial review focusing on some of the reserves requiring most judgement was carried out by PricewaterhouseCoopers LLP for the Directors of the Company.

Internal control and Group Audit

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

The Group's Financial Reporting Control Framework ("FRCF") is part of its wider internal controls system. It addresses financial reporting risks. The Board delegates supervision of the FRCF to the Audit Committee and the CFO is responsible for the FRCF on a day-to-day basis.

During 2017, the Committee received regular reports on the FRCF and the testing of it. Part of those reports focused on control deficiencies, compensating controls and the mitigating actions taken by management.

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

The Committee provides oversight of Group Audit's work and seeks to ensure it adopts industry best practice appropriately. The Group Head of Audit's primary reporting line is to the Chair of the Committee. The secondary reporting line, for day-to-day administration, is to the CFO. Group Audit provides the Committee with independent and objective reports on the adequacy and effectiveness of the Group's governance, risk management and internal controls. The Committee approves Group Audit's annual plan and receives quarterly reports detailing internal audit activity, key findings, management responses, and proposed action plans. Group Audit also monitors that the most significant actions are completed. The Committee also approves the Group Audit Charter.

During the year, the Chair of the Committee attended the Group Audit function's offsite day to aid the Committee in assessing whether the function was effective. This was in addition to regular interaction between the Chair of the Committee and the Group Head of Audit and the wider audit team. Following feedback from the Chair, and having reviewed a report from Company Secretariat, the Committee concluded that the function was effective and that it had the appropriate resources.

Additional information

The Committee has unrestricted access to management and external advisers to help discharge its duties. It is satisfied that in 2017 it received sufficient, reliable and timely information to perform its responsibilities effectively.

The Actuarial Director, external actuarial advisers, External Auditor and Group Head of Audit meet privately with the Audit Committee, in the absence of management.

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

External audit

Deloitte LLP ("**Deloitte**") has served as the Company's Auditor since 2000. Before listing, the Group was audited as a division of RBS Group. The Committee is responsible for overseeing the External Auditor and agreeing the audit fee. This also involves approving the scope of the External Auditor's annual plan.

During the year, the Committee discussed the position on its external audit services contract and examined a number of options regarding the timing of tendering for the external audit, including the mandatory rotation of the Group's audit firm, taking into account the reforms of the audit market by the Competition and Markets Authority and the EU. This included whether it was appropriate to tender the external audit contract for the year ending 31 December 2019.

The Committee decided that it was not appropriate to tender the external audit contract for the 2019 year end and, subject to continued effective performance by Deloitte, would review the position again in 2018 in relation to the 2020 year end. At that point a decision will be made whether to tender the external audit contract for the year ended 31 December 2020 or defer until a later date. A number of factors were taken into account, including anticipated business changes, regulatory developments such as the new insurance accounting standard for implementation in 2021 and the appointment of a new audit partner by Deloitte during 2016, following the normal audit partner rotation process. The current audit partner is Colin Rawlings who was first appointed for the 2016 audit. The Committee has reviewed the latest public report on Deloitte, issued by the Financial Reporting Council's Audit Quality Review Team, and has discussed the findings with Colin Rawlings and made enquiries as to how those findings relevant to the audit of Direct Line Group have been addressed.

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

The Company has complied with the provisions of the Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.

Auditor independence and non-audit services policy

The Group has an Independence of External Auditors Minimum Standard. This establishes parameters for preventing or mitigating anything that compromises the External Auditor's independence or objectivity. The Minimum Standard covers: (i) the provision of audit and non-audit services; (ii) employment of audit employees by the Group and of Group employees by the external audit firm; and (iii) rotation of key audit employees. The Committee reviews and refreshes the standard annually to make sure it remains appropriate. The standard is compliant with the FRC's implementation of the EU Audit Regulation and Directive in adopting the list of prohibited non-audit services which cannot be provided to the Group.

Before each financial year, the Committee formally approves a list of audit-related services that the External Auditor can provide. This is in accordance with the Minimum Standard.

The Group has delegated authority to the Audit Committee's Chair to approve any non-audit services provided by the External Auditor costing up to £100,000. Non-audit services costing over £100,000 require the Committee's approval. Each year, the Committee receives and reviews a report on expenditure on non-audit services.

During the year, the Committee approved fees of £0.2 million to Deloitte for services unrelated to audit work. The following is a breakdown of fees paid to Deloitte for the year ended 31 December 2017.

	Fees £m	Proportion
Audit fees[1]	1.9	90.5%
Non-audit fees	0.2	9.5%
Total fees for audit and other services	2.1	100%

The non-audit fee of £0.2 million related to: (i) audit-related assurance services; (ii) services provided in reviewing the Group's executive crisis management advice and training; (iii) supporting the Group HR Director on remuneration matters; and (iv) assurance services in relation to the issuance of Restricted Tier 1 notes.

The Committee reviewed how the Group applied its Minimum Standard on audit and non-audit services in 2017. It is satisfied that the Group has adequate procedures to ensure that the External Auditors are independent and objective.

Effectiveness of the external audit process and re-appointing Deloitte as External Auditor

In 2017, the Committee assessed the External Auditor's effectiveness. This was in addition to regularly questioning the External Auditor during its meetings. The Committee assessed the External Auditor through: (i) a detailed questionnaire completed by key stakeholders; (ii) discussing matters with the CFO; (iii) formally reviewing Deloitte's independence; and (iv) assessing whether it fulfilled the agreed audit plan.

The Committee, after taking into account all of the information available, concluded that Deloitte had performed its obligations effectively and appropriately as External Auditor to the Group.

The Committee subsequently recommended to the Board that the Group re-appoint Deloitte as External Auditor. The Group will put a resolution regarding this to shareholders at the 2018 AGM.

The Board reviewed and approved this report on 26 February 2018.

Andrew Palmer
Chair of the Audit Committee

Note:
1. You can find further information in note 10 to the consolidated financial statements.

Areas of focus in the reporting period

- The Group is focused on making insurance much easier and better value for its customers. The Committee reviewed and challenged the design and embedding of action plans developed to improve the management of customer complaints, including the plans to re-energise the training and coaching of staff to support improvements in complaint handling. The Committee probed management on the top five complaint categories for each of Personal Lines, Claims and Commercial and the activities planned to improve customer journeys.
- The Group is progressing multi-year transformation programmes to upgrade its operating systems for Personal Lines and Commercial customers aimed at improving customer experience, covering pricing and other related data and digital systems across the business. The Committee regularly scrutinised and challenged the plans, progress, governance and key risks relating to these programmes including in relation to build, testing and deployment. In addition, the Committee monitored these programmes in the context of seeking to achieve the planned benefits to customers. The Committee also considered the outputs of reviews undertaken by the Risk function regarding these programmes.
- In October 2017, the Group received approval from the PRA following a 'Major' change to the IECM. The 'Major' change was due to the accumulation of 'Minor' model changes since the IECM had previously been approved by the PRA. The Committee reviewed and challenged the application to the PRA, including the details of and rationale for all model changes, together with the impacts on the SCR and the governance process for the model changes. The Committee also scrutinised reports from the Risk Function and Group Audit on IECM validation and the control environment respectively.
- The European Union General Data Protection Regulation ("EUGDPR") is an important area of focus for companies. The Committee monitored and challenged the plans, progress and governance regarding preparedness for EUGDPR which comes into force on 25 May 2018. The regulations include more stringent requirements on how personal data can be collected and processed and for enhanced privacy rights for individuals. The Committee questioned management on activities and action plans including, in relation to: (i) e-Privacy; (ii) notices of consent; (iii) the scope of the legislation; (iv) data retention; and (v) data portability. Training on EUGDPR was delivered to the Board in 2017.

Jane Hanson
Chair of the Board Risk Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

Main activities during the year

Risk monitoring and oversight

At each scheduled meeting, the Committee received a report from the CRO detailing the Group's current and forward-looking solvency position, and providing outputs of regular risk monitoring and details of specific risks and issues. The report was enhanced during the year to set out more clearly the Group's current risk profile, the areas of management focus and the key activities being undertaken by the risk management function to drive forward the embedding of risk management across the Group.

The Committee received regular reports regarding the three strategic risk appetite statements: maintain capital adequacy; stable and efficient access to funding and liquidity; and maintain stakeholder confidence.

The Committee monitored the Group's exposure against these risk appetite statements and the lower level risk appetite statements, reviewed key risk indicators and assessed the drivers that affect status against risk appetite. The Committee reviewed and questioned the justification of the assessment of certain risks and the robustness of management action plans to address areas close to or outside tolerance. The extent of change being executed continued to be an area of focus for management and the Committee reviewed and challenged the actions taken by management in relation to change risk.

The Committee monitored the Group's risk management and internal control systems, and reviewed their effectiveness. This covered all material risks, including financial, operational and compliance. The Committee reviewed the residual risk position after the operation of controls and considered the effectiveness of any associated mitigating actions and compensating controls. The monitoring and review by the Committee involved examining an assessment of the control environment and material controls at Group level, based on directorate-level risk and control self-assessments. These assessments were subject to challenge by the Risk and Group Audit functions.

On behalf of the Board, the Committee also monitored the Group's risk management systems, and reviewed their effectiveness. This included Horizon, the Group's risk management software, on which the Committee took part in a deep dive workshop to gain a more insightful understanding of the scope and application of the system.

The Committee assessed the principal risks facing the Group, which you can find listed on pages 24 and 25. The Committee achieved this by reviewing and challenging the Group's Material Risk Register in the context of the Group's risk appetite and through consideration of the risk assessment contained in the CRO's report that was discussed at each scheduled meeting.

The Committee reviewed the third annual Assessment of Risk Behaviours and Attitudes undertaken jointly by the Risk function and Group Audit, which covered areas including: tone from the top; decision-making; and risk management. The Committee challenged the outputs of the assessment, as well as areas for further improvement, and ensured the appropriateness of the actions identified. The Committee also considered the activities of the Risk function in driving a good risk culture across the Group through mechanisms such as training and its internal communication strategy. The Committee commended the continued progress made in embedding risk management and demonstrating positive culture and behaviours in risk management.

The Committee undertook a deep dive on the Commercial division, focusing on its governance processes, control environment and risk profile. Challenges from the Committee included assessing the enhancements of controls relating to pricing and budgeting as well as the improvements to reinsurance data collection processes.

Additionally, the Committee considered other subjects in more detail at each scheduled meeting. These included: compliance and regulatory risk including oversight of the Group's regulatory relationships; operational risk; financial risk, Solvency II and IECM; emerging risks; and risk governance.

Customer and Conduct

The Group aims to make insurance much easier and better value for its customers by endeavouring to deliver on its commitments and seeking to ensure that fairness is a natural outcome of what the Group does. The Committee reviewed and challenged reports relating to the Group's conduct towards its customers, to gain assurance that customer expectations and outcomes were reasonable and appropriate and to determine that the Group was operating within its defined conduct risk appetite, as set by the Board.

At the Committee's meeting in February 2017, and following the transfer of responsibility for ownership of the Group's Conduct Policy from the Risk function to management, the Committee reviewed and challenged reports from management on conduct culture and customer complaints.

At the Committee's meeting in November 2017, and as detailed in the areas of focus on page 65, the Committee undertook a deep dive on customer complaints and reviewed and challenged the action plans designed by management to reduce customer complaints and improve customer experience.

Compliance and regulatory risk

During the year, the Committee considered the Group's compliance with regulatory requirements including conduct and financial crime. The Committee approved the annual Compliance Plan which sets out the compliance activities which will be undertaken in the upcoming year with the objectives of: (i) ensuring compliance; (ii) maintaining an open and co-operative relationship with regulators; and (iii) ensuring the Board and employees understand their regulatory responsibilities.

The Committee reviewed and challenged the outputs from conduct and compliance assurance reviews, including in relation to Solvency II compliance.

The Committee reviewed the Group's Regulatory Governance Map and received updates on regulatory interactions, particularly with the FCA and PRA. The Committee also received updates on relevant regulatory developments, including an update on the changes to the Senior Manager and Certification Regime. The regime now covers employees who are considered to be performing functions which are of specific importance to the sound and prudent management of the firm.

The Committee received regular reports on the Group's actions to prevent financial crime, including reviewing the annual Financial Crime Report.

Operational risk

The Committee continued to review and challenge IT controls, including risks relating to IT systems' stability, cyber security, technology resilience and the internal control environment. The Committee assessed the level of prevention, protection and detection in relation to cyber risk and the residual risk for each of the IT control areas, taking into account any compensating controls and/or mitigating actions. The Committee questioned the impact of system stability issues in relation to customer and conduct metrics, including call abandonment rates. The Committee also reviewed IT risk appetite statements to gain assurance that these were appropriate and in line with the overarching Group risk appetite.

As detailed in the areas of focus on page 65, the Committee received regular updates on the Group's multi-year transformation programmes, including the development of the next generation of customer systems for Personal Lines and Commercial. The Committee monitored and examined the oversight and challenge of major change initiatives by the Risk function and reviewed the outputs of the assurance work undertaken by the Risk function and Group Audit.

Financial risk

At each meeting, the Committee monitored the Group's performance against capital risk appetite through the CRO's report. Committee members considered financial risks in the strategic plan against risk appetite. Committee members also reviewed and challenged the ORSA report and subsequently recommended the report for approval to the Board. Challenges on the ORSA included those in relation to stress testing of the strategic plan, distribution risk, internal model validation activity and contingent management actions.

The Committee reviewed and challenged the stress and scenario testing plan prioritising the importance of certain scenarios. The Committee also examined the outputs of the budget stress tests and the associated management actions, where necessary, required to keep the Group within risk appetite.

The Committee also reviewed the application to the PRA regarding the 'Major' model change, which included the impact it would have on the SCR. For more information on the 'Major' model change please see the areas of focus section on page 65.

Throughout the year the Committee received reports on the IECM, including independent validation results and the IECM Owners' report. This outlined the scope of the IECM, key outputs, risk drivers, significant parameters, expert judgements and key assumptions. The Committee challenged management on the assumptions in relation to the reinsurance decision-making process in the context of the Group's risk appetite as a result of reviewing the IECM Owners' report.

Emerging risks

During the year, the Committee held a strategy day where it considered management's response to the emerging risks to the business, and challenged the assumption that management had identified all possible emerging risks. The Committee also challenged the Risk function's role in ensuring that these risks were being monitored and managed appropriately. The Committee undertook a deep dive into risks arising from autonomous car technology and from potential new market entrants. The Committee also challenged the possible opportunities in emerging risks, particularly regarding the use of data in pricing.

Risk governance

Every year, the Committee reviews and approves the ERMF, which includes details of the Group's Policies and Minimum Standards. The Committee reviewed and challenged each Group Policy and the Regulatory Governance Map as part of the Group's Solvency II requirements and recommended them for approval by the Board. The Committee also considered the results of the annual Group assessment of the effectiveness of the internal control environment undertaken by each business directorate, as well as monitoring controls on an ongoing basis.

The Committee considered, challenged and approved the Annual Risk and Compliance operational plan and the adequacy and objectivity of the Risk function's resources.

Whistleblowing

The Committee reviewed the arrangements by which employees may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters ("**whistleblowing**"). The Committee also reviewed reports relating to whistleblowing to ensure arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action. The Committee probed management and was satisfied that the whistleblowing process met the necessary standards and that it was adequately designed, operated effectively and adhered to regulatory requirements.

Anti-Bribery and Corruption

Annually, the Committee considers an anti-bribery and corruption ("**ABC**") report, which includes an annual risk assessment of the level of ABC risk to the Group. Following review and challenge, the Committee was satisfied that the Group's policies and procedures on ABC were fit for purpose and ABC risks were managed appropriately.

Additional information

The Committee has unrestricted access to management and external advisers to help discharge its duties. It is satisfied that in 2017 it received sufficient, reliable and timely information to perform its responsibilities effectively.

In addition to monthly one-to-one meetings with the Chair, the CRO also met privately with the Committee without management being present.

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

The Board reviewed and approved this report on 26 February 2018.

Jane Hanson

Jane Hanson
Chair of the Board Risk Committee

Corporate Social Responsibility ("CSR") Committee report

Sebastian James
Chair of the CSR Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

Areas of focus in the reporting period

- The Committee's principal focus during 2017 was on "Shotgun", the CSR initiative designed with the ambitious goal of seeking to reduce young driver deaths in their first 1,000 miles of driving to zero. The Committee received reports at each meeting on the development of the app and the key milestones.
- The Committee reviewed the progress achieved in the year in relation to the community. This included responding to the fire at the Grenfell Tower, London, in June 2017 and to the terror attacks which took place in the UK in 2017. The Committee supported management in its decisions to fund a project to help tower block tenants build resilience and in providing support for the British Red Cross, respectively.
- The Committee challenged management on the future CSR strategy and in particular the need to create a clearer focus on one or two key themes.
- During the year, the Committee reviewed the key statistics in relation to the gender pay gap, and the work being undertaken to increase the number of women in senior roles. The Committee was delighted to note the continued strong performance in raising employee engagement scores across the Group, as measured by the annual employee survey, and continues to push for initiatives to further increase engagement.

Main activities during the year

The Committee monitors the implementation of the CSR strategy through regular updates on the different focus areas and challenges the robustness of, and progress against, targets relating to each strand of the CSR strategy. The Committee also ensures that best practice and thinking across the market is considered as part of the Group's own CSR approach.

CSR strategy

The Group's CSR strategy for the year focused on four areas. They are: (i) Helping to make our society safer (Shotgun); (ii) Proud to be here; (iii) Being recognised as part of our communities; and (iv) Reduce, Reuse and Recycle. A member of the Executive Committee sponsored each area.

In December 2017, the Committee approved a new CSR strategy which has two overarching goals: 'Protecting Britain's road users' and 'Reflecting an ever-changing Britain'. The priority for each goal is Shotgun and Diversity and Inclusion respectively.

Helping to make our society safer (Shotgun):

During the year, the Committee received progress updates at each meeting on Shotgun. You can find further details on Shotgun and about the Group's priorities in the CSR report on pages 26 to 29.

Proud to be here

The objective of this area of focus is to improve employee engagement as a key enabler of the Group's 2017 strategy. The KPIs for this element are linked to the People Strategy and focus on employee engagement, diversity and inclusion. The Committee also reviewed the Group's policy on compliance with the Modern Slavery Act 2015. This included reviewing internal compliance and how third-party suppliers complied with the requirements under the Act.

Being recognised as part of our communities

The Committee reviewed progress on strengthening the level of support provided by the Group to the network of Community and Social Committees operating across the Group. The Committee challenged the main targets which related to volunteering, fund raising, matched payroll giving; and the Community Cashback scheme, a scheme which supports the causes and community groups which employees felt most passionately about when they fundraise or volunteer in their own time.

The 'One Day' volunteering initiative, which gives employees paid leave to volunteer in their local community, and Community Cashback scheme continued to be considered the two areas with the greatest potential for impact. These arrangements encourage colleagues to take part and raise funds for local causes.

Reduce, Reuse and Recycle

This strand of the strategy considers energy use, waste management and resource use within the Group's operations and environmental and social matters in the Group's supply chain. The Committee reviewed the key objectives related to reducing greenhouse gas ("GHG") emissions, diverting waste from landfill, and challenged the targets, including the new targets for waste recycling across the Group's accident and repair centres.

CSR activities

The Committee was kept up to date with the Group's external positioning, including the Group's stakeholders and its approach to managing external relationships, which included the use of the corporate website and the AGM. The Committee continues to challenge management's approach to ensure that it is both authentic and strategic, and that it continues to focus on initiatives with real potential to improve lives. The Committee monitored the Group's performance against the targets set in relation to CSR KPIs.

The Committee reviewed the CSR-related feedback received from proxy voting advisers and encouraged management to consider addressing the relevant feedback.

The Board reviewed and approved this report on 26 February 2018.

Sebastian James
Chair of the CSR Committee

Areas of focus in the reporting period

- The Committee reviewed the Group's liquidity needs under stress scenarios in order to assess the adequacy of liquidity held within the investment portfolio. The Committee looked to strike a balance between possible short-term liquidity requirements (without the need to sell assets, potentially incurring capital losses) and income foregone. The overall requirement was reduced in response to outputs from catastrophe modelling, while overnight requirements were increased in the light of collateral requirements observed following the depreciation of Sterling immediately after the EU referendum. The Committee also received a separate report on planned changes under EU money market reform which will impact the future investment of cash assets.
- At the meeting in January 2017, the Committee approved the proposal by the Investment & Treasury department to bring in-house the management of certain Sterling investment grade fixed income assets as part of the drive to deliver a more cost-effective investment operating model. Approval followed a long period of scrutiny by the Committee starting early in 2016, during which time an independent assessment was received on the adequacy of credit selection and monitoring processes to be employed and the results from a model portfolio examined on several occasions. Later in 2017, the Committee received a positive internal audit report which had been requested at the time of authorising the initiative to provide further assurance over the ongoing management of the internally managed portfolios. The report confirmed that the key controls for the internally managed portfolios were operating effectively.
- At the request of the Committee, a study was received examining the efficiency and effectiveness of the present hedging strategy employed to mitigate currency and non-Sterling interest rate risk, as well as considering alternative instruments to achieve the same hedging objectives. The Committee concluded that the present hedging strategy remained appropriate in terms of efficiency and effectiveness.
- The Committee considered research undertaken to identify the most appropriate metrics to employ with regard to sizing the investment risk budget within the context of the Group's other risks (primarily insurance risk), and capital. A number of metrics, with proposed risk appetite limits, were agreed and recommended to the Board.
- The Committee invited the managers of the UK property and US dollar high-yield portfolios to present updates on their respective portfolios, current investing strategy and market outlooks. In the case of the presentation given by the manager of the property portfolio, the Committee requested a report on cladding and fire risk matters. The Committee was satisfied with the performance of both portfolios, current strategy and responses received to questions raised at both presentations.
- The Committee wanted to understand the actions undertaken to comply with the requirements of the Prudent Person Principle ("PPP") under the Solvency II Directive. Following review, the Committee was satisfied that appropriate levels of delegation to management had been put in place; and that management were robustly reviewing investment actions and risks taken against the PPP guidelines.

Andrew Palmer
Chair of the Investment Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

Main activities during the year

Market developments

At each scheduled meeting the Committee received a market update from the Director of Investment Management and Treasury. The update covered economic conditions in the UK, the United States of America and the Eurozone; market levels for key asset classes (notably credit); the outlook for interest rates and inflation; and developing issues viewed as appropriate to be brought to the attention of the Committee. High asset prices, divergent monetary policies pursued by central banks, the expected slowdown in UK annual growth and growing consumer indebtedness shaped the Committee's investment concerns across the course of 2017.

Suitability of investment strategy

An annual asset and liability management study is presented to the Committee each year which informs strategic benchmark allocations and provides part of the context for the addition of new asset classes or exiting a present holding. The Committee was particularly interested this year to understand how the change in the Ogden discount rate, which was announced in February 2017, impacted asset benchmark holdings given changes to the relevant underlying reserves.

Monitoring investment activity and performance

The Committee received a comprehensive report at each scheduled meeting covering: the financial results from investment activity; aggregate portfolio positioning versus strategic benchmarks; performance of each individual portfolio against benchmark; adherence with operational controls; performance of suppliers; and compliance with an agreed framework of risk limits. During 2017, the Committee was particularly interested to understand that (i) the new operating model (following the change of custodian and middle office supplier in 2016), and (ii) Solvency II reporting of assets and derivatives to the PRA, had been implemented and were operating effectively.

The Board reviewed and approved this report on 26 February 2018.

Andrew Palmer
Chair of the Investment Committee

Mike Biggs
Chair of the Nomination Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

Areas of focus in the reporting period

- During 2017, the majority of the Committee's time was devoted to considering the composition of the Board. It ensured that the recruitment process for Non-Executive Directors ("**NEDs**") identified the skills and experience that the Board needs to be able to challenge and support senior management in developing and executing the Group's strategy. It also reviewed Executive succession planning with a view to ensuring that the Group's future leadership will have the qualities needed for the strategic and cultural development of the business.
- As part of its focus on Executive succession planning, and to improve gender and other diversity in the Group's senior management, the Committee continued to encourage management to grow its talent pipeline, both by developing existing employees and by hiring new talent. This is being achieved by: (i) the systematic assessment of potential; (ii) bespoke personal coaching; and (iii) development plans for high-potential employees. The Committee also continued to encourage the targeted recruitment of new senior executives to strengthen general management, leadership and capability in disciplines including strategic development, change management, IT, claims management, data, finance and procurement. In 2017, the Group made 16 external appointments to senior management, 50% of whom were female.
- The Committee chose to use two external search consultants during the year; Egon Zehnder for the Non-Executive position and Heidrick & Struggles for the CFO position. For both consultants, the Committee set the profile and criteria to be used in the search. Mike Holliday-Williams was appointed as Executive Director through the internal talent pipeline.
- The Committee ensured that John Reizenstein and Penny James would work alongside one another to support an orderly transition until John steps down as an Executive Director at the conclusion of the AGM on 10 May 2018. Penny will take over as CFO on 1 March 2018. Her appointment reflects the commitment to seek to attract diverse and effective leadership to drive and deliver the Group's strategy.

Main activities during the year

Board composition

During the year, the Committee: considered the Board's skills and experience; reviewed the structure, size and composition of the Board; reviewed the membership and chairmanship of the Board's Committees; and reviewed NEDs' letters of appointment, terms of appointment and time commitment. The letters of appointment for the Chairman and NEDs set out the time the Group anticipates that they will commit to their roles. This is at least three days a week for the Chairman and an average of three days a month for the other NEDs depending on business needs.

Succession planning

The Committee places great importance on Board and Executive succession planning and monitors its progress as a standing agenda item at each of its scheduled meetings. The Committee guides management in Executive succession planning.

Board changes

There were a number of Board changes during the year. The Company appointed:

- Danuta Gray as a NED with effect from 1 February 2017;
- Mike Holliday-Williams as an Executive Director with effect from 1 February 2017; and
- Penny James as an Executive Director and CFO-designate with effect from 1 November 2017.

The Company also announced that John Reizenstein and Andrew Palmer would not seek re-election at the Company's AGM on 10 May 2018. The Committee also recommended the appointment of Danuta Gray as a member of the Remuneration Committee and Nomination Committee, and John Reizenstein as a member of the Investment Committee, all of which the Board subsequently approved. The Committee continues to monitor the membership of the Board's Committees to ensure that each Committee has a suitable balance of skills as well as taking into consideration the length of service of the members.

Board appointment and reappointment process

The Committee oversaw the process to appoint Danuta Gray as a Non-Executive Director and Penny James as an Executive Director and CFO-designate. The process to appoint Danuta was disclosed in the 2016 Annual Report & Accounts. For the appointment of Penny James, the Committee produced a detailed brief and engaged external search consultants, Heidrick & Struggles, to find suitable candidates.

Heidrick & Struggles prepared a long list of candidates of appropriate merit from diverse backgrounds for the position. The Committee agreed a shortlist for the role and interviewed candidates. It then approached the PRA and FCA for approval, and recommended appointing Penny James as an Executive Director and CFO-designate to the Board.

Heidrick & Struggles is a signatory to the Voluntary Code of Conduct for executive search firms. The firm is not connected in any way to the Company.

As Penny James was appointed since the last AGM, she will submit herself for election at the Company's 2018 AGM.

Following regulatory approval, the Committee also recommended the appointment of Mike Holliday-Williams to the Board in recognition of his leadership of the Personal Lines business and to leverage his expertise for the benefit of all of the Group's businesses.

Electing and re-electing Directors

Before recommending the proposed election or re-election of Directors at the 2017 AGM, the Committee reviewed the independence of NEDs. It concluded that Danuta Gray, Jane Hanson, Sebastian James, Andrew Palmer, Clare Thompson and Richard Ward were all independent within the Code's meaning. Jane Hanson, Clare Thompson and Mike Biggs have served on the Board since December 2011, September 2012 and April 2012 respectively. In accordance with the Code, the extension of their terms of appointment beyond six years has been the subject of a particularly rigorous review by the Committee. Mike Biggs, as Chairman of the Board and Chair of the Committee, was not involved in his own review.

The Board is satisfied that Jane and Clare remain independent and that all three continue to make a significant contribution to the Board and its Committees, and provide valuable continuity to the Board. Mike Biggs was independent when appointed as Chairman. The Committee recommended to the Board and shareholders to elect or re-elect all serving Directors at the Company's 2017 AGM.

Diversity

The Group celebrates the diversity of its workforce. The Group seeks to recruit the best candidates for all positions throughout the business. At the date of this report, four of the Group's 11 Directors are women, which equates to 36% of the Board. This meets the target set in Lord Davies' Women on Boards Review Five-Year Summary published in October 2015, to be achieved by 2020. The Group is also aiming to meet the executive-level target set in the Hampton-Alexander Review to be achieved by 2020. The Board acknowledges the benefits of diversity in all respects.

You can find out more about the Group's approach to diversity in the CSR report on page 28 and the Corporate Governance report on page 55.

The Board reviewed and approved this report on 26 February 2018.

Michael N Biggs
Chair of the Nomination Committee

Clare Thompson
Chair of the Remuneration Committee

Membership, attendance and responsibilities of the Committee can be found on pages 49 and 50.

FIT Remuneration Consultants LLP, who act as independent advisers to the Committee, also attend Committee meetings.

Areas of focus in the reporting period

- The Committee completed the review of the Remuneration policy which it had begun in 2016 and which had previously been amended in 2014. The revised Remuneration policy was approved by shareholders at the AGM in May 2017, with over 98% of the votes cast in favour of the policy. The policy is expected to remain in place for the next three years.
- The Committee reviewed the effect of the change in the ODR on the outcome of the 2016 AIP. Whilst the ODR change was not announced until the end of February 2017, it materially impacted the financial results for 2016 and AIP payout. As the return on tangible equity ("**RoTE**") for 2016 was impacted, the vesting level of the long term incentive plan ("**LTIP**") awards granted in 2014 and which vested during 2017 was also reduced. The Committee agreed to keep their assessment of the 2016 AIP outcome under review if the ODR was raised during the year as a result of a further government review. Given the announcements in 2017 from the Ministry of Justice and the Treasury with regards to the process for setting the ODR, the Committee agreed to keep their assessment of the 2016 AIP under review for 2018.
- In anticipation of appointing Penny James as an Executive Director and CFO-designate, the Committee reviewed the remuneration package being offered. Having regard to the long-term success of the Company, as well as the new remuneration policy and the calibre of candidate being sought, the Committee agreed on the remuneration package to be offered to Ms James. This included agreeing those elements of Ms James' remuneration to be bought out from her previous employer and the terms of the buy-out.
- Towards the end of the year the Committee reviewed the impact of the tender offer to purchase half the Group's subordinated notes and the issue of new Tier 1 notes (the "**capital management exercises**"). Whilst these transactions had a neutral effect overall on the capital position of the Group, the IFRS profit for 2017 was reduced by a one-off charge which related to the premium paid to redeem the notes in issue. The Committee exercised its discretion to adjust the financial outcome so that the impact on the IFRS profit was excluded from the 2017 AIP outturn.

Main activities during the year

Annual incentive plan

During the year, the Committee monitored the operation of the AIP. For the 2016 financial year, this involved reviewing the Group's financial performance, in particular the effect of the change in the ODR, and assessing the Group's performance against the targets that the Committee set at the start of the year. It also received reports from the Chairs of the Audit and Board Risk Committees about whether the Group had achieved the required performance within risk appetite. The Committee also concluded that no malus or clawback of previous awards was required in 2017.

For the 2017 financial year, the Committee approved the performance metrics which included new customer measures and people measures. The Committee also monitored performance against the 2017 targets and subsequently reviewed the full year performance. The Committee also discussed the performance metrics for the 2018 AIP and approved them, being satisfied that they were sufficiently challenging.

Long-term incentives

During 2017, the Committee reviewed and approved the level of vesting of the 2014 awards made under the Company's LTIP against the performance criteria. These awards had two performance metrics based on RoTE and total shareholder return ("**TSR**"). After assessing performance against these metrics, the awards vested in March at a level of 85.6% and in August at a level of 79.2%. When considering the RoTE performance for 2016, the Committee discussed the impact of the ODR change which did not become effective until February 2017, but impacted the results of the 2016 financial year. This was important to the Committee because the timing of the announcement (two months after the year end) meant that executive management did not have the ability to make adjustments to prices or costs to allow for the amended ODR and the related fall in profit. Following consideration, the Committee decided not to make any adjustment to the RoTE outturn even though the ODR change reduced RoTE by approximately 30% and consequently materially impacted the LTIP outturn. Before vesting, the Committee considered the LTIPs' financial and risk underpins. The Committee also determined the quantum of awards made in 2017 under the LTIP in view of business and individual performance.

The Committee considered the RoTE and TSR targets to ensure they remain challenging in the context of the Group's planned performance, in particular noting the impact of the capital management exercises on RoTE and ensured this was taken into account for awards to be granted in 2018.

Impact of capital management exercises on incentive schemes

When considering the impact of the capital management exercises on the incentive schemes, the Committee concluded, taking into consideration the Board's view that these transactions were in the best interests of the Group and its shareholders, that it was not appropriate that management be penalised for them in the incentive scheme outcomes. The Committee therefore determined that the AIP outturn for 2017 should be adjusted for the one-off cost to IFRS profit.

In addition, the Committee concluded that the favourable impact on RoTE should be excluded from the RoTE performance for the in-flight LTIP awards. Therefore, the 2017 RoTE outcome for the awards granted in 2015 was adjusted downwards. Similarly, the reported RoTE in 2018 and 2019 will be adjusted downwards for the remaining in-flight LTIP awards. The ongoing enhancement to earnings expected in future years has been recognised by the Committee in setting higher RoTE targets than would otherwise be the case for the LTIP for awards to be granted in 2018.

Directors and other senior executives

Mike Holliday-Williams, Managing Director, Personal Lines, joined the Board on 1 February 2017. He did not receive a salary increase as a result of the promotion and his AIP and LTIP opportunity were set at the same level as John Reizenstein, the CFO. During the year the Committee approved the vesting of the final tranche of his buy-out shares awarded when he initially joined the Group in 2014.

The Committee considered the impact of John Reizenstein's planned retirement as CFO on his variable remuneration arrangements and confirmed his "good leaver" status without the exercise of any discretion.

During the year, the Committee reviewed and approved the level and structure of the pay and incentives of the Executive Directors and other senior executives. Additionally, it reviewed remuneration for the strategic leadership team. As part of this review, the Committee considered the Share Ownership Guidelines for the Executive Directors and Executive Committee members.

Solvency II-identified staff

The Committee reviewed and approved the Group's remuneration policy statement and register of identified staff before submission to the PRA in January 2018. The Committee's remit includes oversight of the remuneration of Solvency II-identified staff. Remuneration for control functions, which are Corporate Actuarial, Compliance, Group Audit and Risk, was considered against specific arrangements appropriate to those roles.

Regulatory landscape

Throughout the year the Committee received regular briefings on external developments in relation to remuneration in order to consider and plan for potential changes.

Remuneration strategy

As part of the remuneration policy review, the Committee reaffirmed the remuneration strategy to provide a clear and simple framework for remunerating the Company's Executive Directors, and aligning their variable pay opportunity to the business strategy and the Company's demonstrable success.

Interaction with other Board Committees

The Committee believes that it is important to have clear lines of communication with other key Board committees. To this end the Chair of the Audit Committee is currently a member of the Committee and the Chair of the Board Risk Committee attends Committee meetings at relevant times during the year. Generally, this is: when the Committee is discussing the performance of senior executives or regulated employees; during the discussions on the outcomes of the incentive arrangements; or when there are new legislative or regulatory requirements. At these times the Committee considers it important to take into account factors that the Chairs of the Audit and Board Risk Committees consider appropriate in relation to risk management and the control environment.

In addition to attending Committee meetings, the Chair of the Board Risk Committee, with input from the Chair of the Audit Committee, provides a certificate to the Committee on her assessment of whether the AIP outcome has been achieved within risk appetite and on the quality of earnings. Also, before any long-term incentives can vest, the Board Risk Committee Chair is consulted and the Committee takes a formal decision on whether the incentives are allowed to vest and/or whether to operate the malus and/or clawback clauses in the incentive schemes rules.

If it is felt necessary, the Remuneration Committee and the Board Risk Committee can hold joint sessions to discuss relevant regulatory developments that are best dealt with by the Committees operating and discussing the issues together.

The Board reviewed and approved this report on 26 February 2018.

Clare Thompson
Chair of the Remuneration Committee

The Remuneration Committee is committed to aligning Executive Directors' pay to the Group's business strategy and demonstrable success, and the interests of our shareholders.

Clare Thompson
Chair of the Remuneration Committee

Dear shareholders,

As the Chair of the Remuneration Committee (the "Committee"), I am pleased to introduce our report on Directors' remuneration for the 2017 financial year.

We have set out this report in the following sections:

Section	Pages
Remuneration at a glance – summarising the remuneration arrangements for Executive Directors	76 to 77
Annual report on remuneration – detailing pay outcomes for 2017 and covering how the Group will implement its remuneration policy in 2018	78 to 93
Summary of policy approved at the 2017 AGM	94 to 99

Consistent with the regulations, our Directors' remuneration policy was resubmitted to the Company's AGM on 11 May 2017 and approved by a significant majority of shareholders (98% voted in favour). We are pleased with the support shown by our shareholders to the work of this Committee and hope that you will equally agree with how we have applied that policy during 2017 and plan to do so in 2018.

Pay outcomes for 2017

Helped by focusing on the value, service and brand propositions we offer to our customers, and maintaining underwriting discipline, 2017 was another strong year for the Group with PBT of £539m. This outturn was ahead of the target thereby leading to a maximum payout for this element under the Annual Incentive Plan ("**AIP**").

Overall, performance on both the customer and people metrics under the strategic measures was also strong, resulting in an achievement of 84%, with an on-target achievement for the personal objective (60%).

The only adjustment from the statutory IFRS basis was to exclude the exceptional in-year costs of the capital management exercises. It is considered best practice to neutralise such transactions and the Committee concluded this was appropriate given the Board's view that this unbudgeted finance cost was in the interests of the Company and shareholders, and that management should not be penalised for it. Given the level of outperformance of the target, this in fact had no impact on the outturn.

We therefore awarded bonuses of 88% of the maximum to the Executive Directors. In line with the remuneration policy, 40% of any AIP award is automatically deferred into a Deferred Annual Incentive Plan ("**DAIP**") award.

Shareholders may recall that, at the time of the approval of the 2016 AIP outturn, the Government had just announced a change in the Ogden discount rate (February 2017) which materially impacted the financial results for 2016. To align the 2016 AIP outturn with the shareholder experience, the Committee significantly reduced the AIP outturn, but agreed, in these exceptional circumstances, to keep its assessment of the 2016 AIP outcome under review until the end of 2017. This would enable the Committee to recalculate the outturn for the 2016 financial year if the Ogden discount rate was raised or the mechanism for setting it was changed during 2017. The Government indeed made announcements in this regard but is proceeding at a slower pace than anticipated and, while it has stated that the mechanism needs reform, no legislation has been forthcoming. A new rate therefore is still to be announced. The Committee noted that, in reducing the AIP outturn in 2016, it operated more conservatively than many of its competitors and, as it remains unclear whether the reduction taken in 2016 was appropriate, it has agreed to extend the review period for the 2016 AIP until the end of 2018.

For the 2018 AIP we will continue with the balanced scorecard of financial and strategic measures. No change will be made to the current weightings and assessment approach.

The Long-Term Incentive Plan ("**LTIP**") has two performance measures: Return on Tangible Equity ("**RoTE**") (60% of the total award) and Total Shareholder Return ("**TSR**") (40% of the total award).

Awards under the LTIP granted in March and August 2014 vested during 2017. The Group achieved an average RoTE of 16.2% over 2014, 2015 and 2016 resulting in 76% of the maximum potential vesting of the RoTE element (45.6% of the total award).

The Company's TSR performance over the three-year vesting period was positioned above upper quintile against its comparator group for the March 2014 awards and slightly below the upper quintile for the August 2014 awards. This resulted in 100% and 83.9% respectively of the maximum potential vesting under the TSR element (40% and 33.6% of the total award).

Overall, 85.6% of the total awards vested in March 2017 and 79.2% in August 2017.

Awards under the LTIP granted in March and August 2015 are due to vest during 2018. This is subject to the Committee's satisfaction that the financial and risk underpins have been met at the end of the vesting period. The RoTE performance period for these awards ended on 31 December 2017. The three-year average RoTE performance for 2015, 2016 and 2017 was 18.1% against a maximum target of 17.5%. Awards under the RoTE element are, therefore, due to vest at 100% of the maximum potential.

In calculating the RoTE achievement, the reported RoTE for 2017 was adjusted downwards in order to exclude the favourable impact of the capital management exercises on the outcome for these awards. The ongoing enhancement to earnings expected in future years has been explicitly recognised by the Committee in setting higher targets than would otherwise be the case.

Consistent with the regulations, the TSR element of the 2015 awards due to vest during 2018 will be reported separately next year. We have included the RoTE vesting outcomes plus the TSR vestings from the 2014 awards in the single figure remuneration table for the Executive Directors.

Approach to pay in 2018

The policy was renewed at the 2017 AGM and included a number of developments in best practice, including the addition of holding periods to new LTIP awards.

No further change to the overall approach to pay is anticipated for 2018:

- The CEO and MD Personal Lines will be awarded a salary increase of 2.5% from 1 April 2018, in line with the average rate for staff generally. No increase will be awarded to the CFO-designate or the CFO in light of the former's package having just been set and the latter's pending retirement.
- No change will be made to either the weighting or the approach to assessment of the financial metric under the AIP.
- We are not proposing any changes to the performance conditions for the 2018 awards under the LTIP. However, the RoTE scale will be increased from the current range of 15% to 18% to a range of 17.5% to 20.5%. This increased range reflects both the beneficial impact of the capital management exercises and the Group's planned underlying RoTE performance.

The Committee is monitoring potential changes to the Corporate Governance Code, including regarding publishing a ratio of CEO to all-employee pay, and will adopt such practices once the preferred methodology has been confirmed.

Chief Financial Officer

During the year Penny James was appointed to succeed John Reizenstein as Chief Financial Officer and will become the CFO on 1 March 2018. Mr Reizenstein will step down from the Board at the AGM and leave the Group in the autumn.

In setting Ms James' remuneration, the principle we followed was to replicate the value of her previous total remuneration package, including compensating her for awards forfeited on leaving her previous employer. The details are fully set out on page 92 of the report.

For Mr Reizenstein, the Committee noted that he was retiring and, on that basis, confirmed his "good leaver" status without the exercise of any discretion.

Your AGM vote

I hope that, having read the information in this report and considering the performance of the Group during 2017, you will vote in support of the Remuneration resolution at the AGM.

Yours sincerely

Clare Thompson
Chair of the Remuneration Committee

Remuneration at a glance

Implementing the policy in 2018

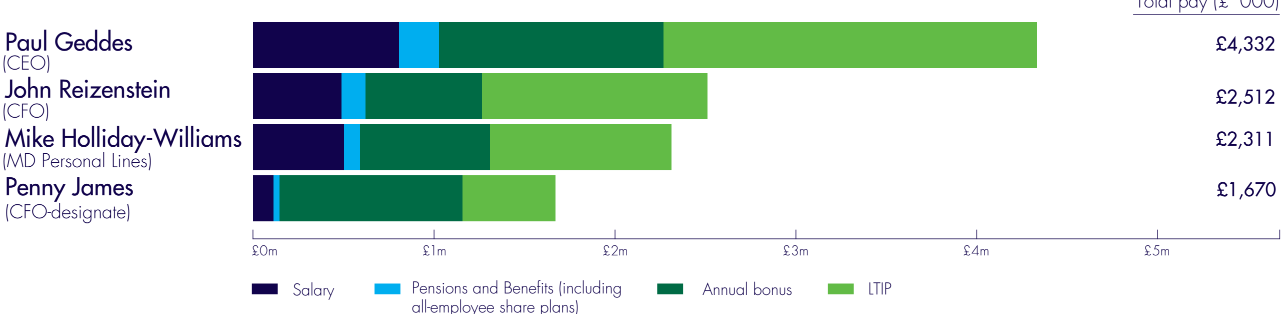
Key feature	Implementation in 2018
Base salary	
• Reviewed annually with any increases taking effect on 1 April • The Committee considers a range of factors when determining salaries, including pay increases throughout the Group, individual performance and market data	• 2.5% salary increase for the CEO to £830,754 • 2.5% salary increase for the MD Personal Lines to £562,584 • No increase was awarded to either the CFO or CFO-designate
Pensions	
• CEO, CFO and CFO-designate contribution rate of 25% of salary • MD Personal Lines contribution rate of 15% of salary	• No change
Annual Incentive Plan (AIP)	
• Maximum opportunity remains at 175% of salary for the CEO and for the CFO-designate, and 150% for the other Executive Directors; 40% of the award is deferred into shares, typically vesting after three years • At least 50% of bonus is based on financial measures. The Committee considers various non-financial and strategic performance measures. It bases its judgement on the payment outcome at the end of the performance period on its assessment of the level of stretch inherent in targets • Any payment is subject to an additional gateway assessment, including assessing risk factors • Malus and clawback conditions apply	• No change to the weighting or measures used for 2018
Long-Term Incentive Plan (LTIP)	
• Awards typically granted as nil-cost options • Awards typically granted every six months at half the annual level • The Plan allows for awards with a maximum value of 200% of base salary per financial year • Performance is measured over three years and determined by RoTE and relative TSR measures • Awards vest subject to financial underpin and payment gateway • Malus and clawback conditions apply • Awards are subject to an additional two-year holding period following the end of the three-year performance period	• No change to the maximum annual award levels • Nil-cost options will continue to be used for the grants • The current 60% RoTE and 40% TSR mix will continue to apply • Increase to the level of RoTE required for the 2018 awards to vest from the current range of 15.0% to 18.0% to a range of 17.5% to 20.5%

Find out more on page 94

Executive Directors' total pay

Find out more on page 79

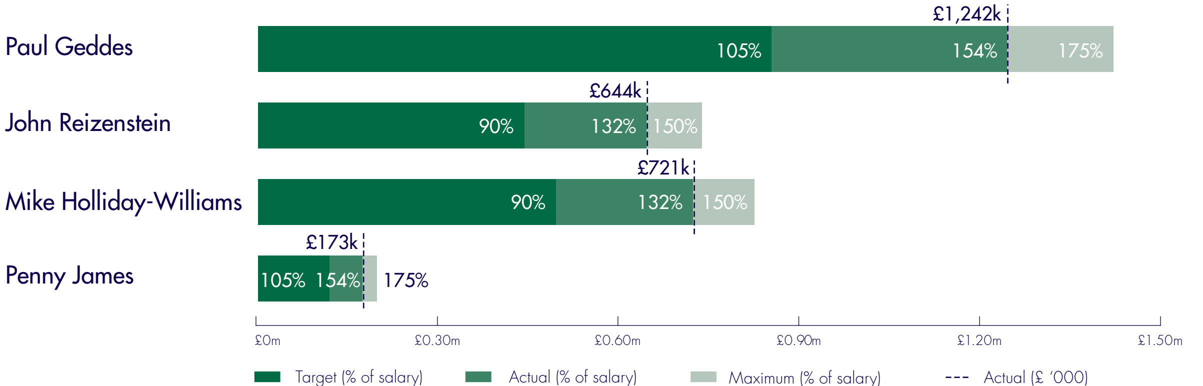
This chart illustrates the total remuneration components received in 2017.



AIP achievement

Find out more on pages 80 to 81

This chart illustrates the actual amounts earned from the AIP and reflecting performance in 2017. 60% of the amount will be payable in March 2018 and 40% will be deferred into shares for three years.

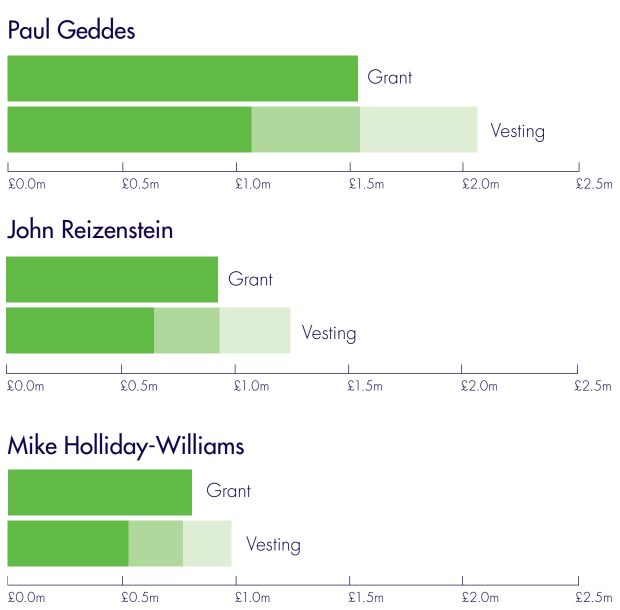


LTIP

Find out more on page 82 & 85

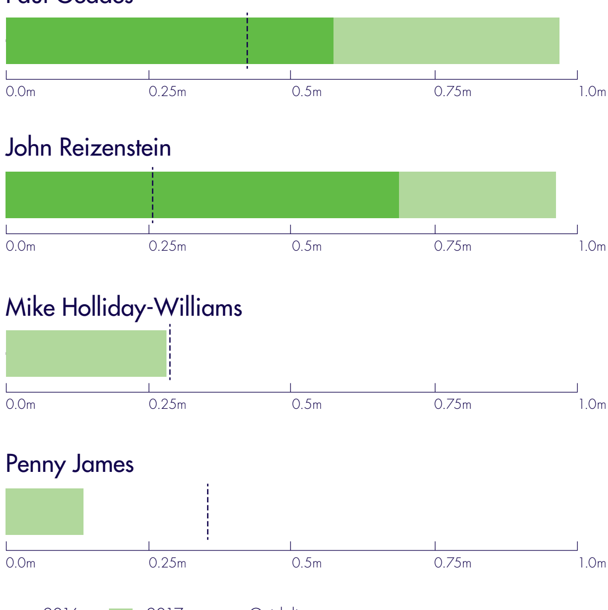
Release of value

This chart illustrates the total value of the March and August 2014 LTIP awards that vested in 2017.



Shareholding at year end

This chart illustrates the number of shares held at the end of 2017 by the Executive Directors against the share ownership guidelines of 200% of salary.



Statutory remuneration report

Introduction

We have prepared this remuneration report in accordance with the requirements of the Companies Act 2006 and the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended) (the "Regulations"). The report also meets the relevant requirements of the Listing Rules of the Financial Conduct Authority, and describes how the Board has complied with the principles and provisions of the UK Corporate Governance Code relating to remuneration matters. Remuneration tables subject to audit in accordance with the relevant statutory requirements are contained in the annual remuneration report and stated to be audited. Unless otherwise stated, the information within this Directors' remuneration report is unaudited.

Annual remuneration report

Remuneration Committee members and governance

The following list details members of the Remuneration Committee during 2017. You can find information about each member's attendance at meetings on page 49. You can find their biographies on pages 46 and 47.

Committee Chair
Clare Thompson
Non-Executive Directors
Mike Biggs
Danuta Gray[1]
Sebastian James
Andrew Palmer

Note:
1. Appointed to the Committee with effect from 6 March 2017.

Advisers to the Committee

The Committee consults with the Chief Executive Officer, the Human Resources Director, and senior representatives of the HR, Risk and Finance functions on matters relating to the appropriateness of all remuneration elements for Executive Directors and Executive Committee members. The Chairman, Chief Executive Officer and the Human Resources Director are not present when their remuneration is discussed. The Committee works closely with the Chairs of the Board Risk Committee and the Audit Committee, including receiving input from those Chairs regarding target-setting and payouts under incentive plans, and whether it is appropriate to operate malus and clawback. The Chair of the Audit Committee is currently a member of the Remuneration Committee, and the Chair of the Board Risk Committee attended Remuneration Committee meetings on three occasions. The Remuneration and Board Risk Committees can also hold joint meetings to consider matters of common interest.

The Committee retains FIT Remuneration Consultants LLP ("FIT") as its independent adviser. FIT is a signatory to the Remuneration Consultants Group's Code of Conduct. The Committee appointed FIT when preparing for the IPO and after considering the firm's experience in this sector.

During the year, FIT advised on market practice, corporate governance and regulations, incentive plan design and target-setting, recruitment and other matters that the Committee was considering. FIT does not provide the Company with other services. The Committee is satisfied that the advice FIT provides is objective and independent.

FIT's total fees for remuneration-related advice in 2017 were £125,633 exclusive of VAT. FIT charged its fees based on its standard terms of business for providing advice.

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

Implementing policy and pay outcomes relating to 2017 performance

Single figure table (Audited)

	Salary[1]		Benefits[2]		Annual bonus[3,10]		Long-term incentives[4,5,6,11]		All-employee share plans[7]		Pension		Total	
£'000	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016
Paul Geddes	807	790	18	19	1,242	594	2,063	2,471	–	–	202	197	4,332	4,071
John Reizenstein	488	478	9	10	644	308	1,248	1,495	1	1	122	119	2,512	2,411
Mike Holliday-Williams[8]	501	–	13	–	721	–	1,001	–	–	–	75	–	2,311	–
Penny James[9]	113	–	2	–	1,014	–	513	–	–	–	28	–	1,670	–

Notes:
1. Salary – the Company operates a flexible benefits policy, and salary is reported before any personal elections are made.
2. Benefits – includes a company car or allowance, private medical insurance, life assurance, income protection, health screening and discounted insurance.
3. Annual bonus – includes amounts earned for performance during the year, but deferred for three years under the DAIP. For more information, see page 87. These deferred awards are not subject to any conditions, except continuous employment. However, awards remain subject to malus and clawback.
4. 2014 LTIP awards RoTE – the expected vesting outcome figures for the RoTE portion of the awards granted under the LTIP in 2014 and reported in 2016 have been updated. These updates are based on the actual vesting of the RoTE portion of the awards and a share price of £3.376 and £3.819 on 26 March 2017 and 29 August 2017 respectively, compared to the three-month average share price of £3.55686 used in reporting this figure in the 2016 remuneration report. The revised figures include the actual number of dividends accrued on this portion of the award at vesting. This results in an adjusted reportable increase of approximately £4,855 for Paul Geddes and £2,938 for John Reizenstein, with a corresponding increase of the single figure for 2016 reflected in the table above.
5. 2015 LTIP awards RoTE – the expected levels of vesting are set out on page 82. The corresponding values under long-term incentives, including the estimated value of dividends accrued to 31 December 2017, are £1,135,614 for Paul Geddes, £687,341 for John Reizenstein and £582,738 for Mike Holliday-Williams, based on a three-month average Company share price to 31 December 2017 of £3.65557. Any shares vesting under the LTIP granted in 2015 will not be delivered until the end of the applicable vesting periods in March and August 2018.
6. 2014 LTIP awards TSR – the level of vesting is set out on page 82. The corresponding values under long-term incentives, including the value of dividends on vesting, are £927,109 for Paul Geddes, £561,141 for John Reizenstein and £418,193 for Mike Holliday-Williams, using the share prices on 26 March 2017 and 29 August 2017 of £3.376 and £3.819 respectively.
7. SIP – includes the value of matching shares under the SIP.
8. Mike Holliday-Williams was appointed to the Board on 1 February 2017. His salary, benefits and pension for the purposes of this table have been pro-rated accordingly.
9. Penny James was appointed to the Board on 1 November 2017 and also became employed on that date.
10. The annual bonus figure for Penny James consists of two elements: £173,250 relates to the pro-rated annual bonus for 2017 determined on the same basis as other Executive Directors, £840,841 relates to an estimated payment in lieu of the bonus forfeited at her previous employer as detailed on page 93. The actual payment will be confirmed in next year's report.
11. The long-term incentive figure for Penny James relates to an estimated amount in respect of the first tranche of her buy-out awards disclosed on page 90 which vests in April 2018, and is subject to performance conditions ending in the 2017 performance year. The value is based on an expected level of vesting of 100% and a three-month average share price to 31 December 2017 of £3.65557. The actual vesting will be confirmed in next year's report.

Each Executive Director has confirmed they have not received any other items in the nature of remuneration, other than those already disclosed in the single figure table.

Annual Incentive Plan ("AIP") outcomes for 2017

The Committee established target performance levels at the start of the year. The Committee's approach to setting and assessing PBT targets under the AIP is to set a target level of profit performance and then, at the year end, to assess over- or underperformance by judging overall corporate performance both on an absolute and relative basis. While the Committee does not set a formal threshold to maximum profit range against which performance is formulaically assessed, the Committee's starting point each year has been to look at a range of 10% either side of the targets when discussing the achievement. The Committee again felt this an appropriate basis for its discussions and concluded that the indicative outturn should apply without further adjustment.

The only adjustment from the reported accounting position, as explained in the letter from the Committee Chair, was to exclude the impact of the one-off cost associated with the buying back of the Group's subordinated guaranteed notes which was an unbudgeted initiative to the benefit of the Company and its shareholders. While this, in fact, had no impact on the outturn, given the level of outperformance of the target, it was the correct principle and consistent with best practice and past practice to exclude the impact.

In the table below, we have disclosed the target set for PBT performance. The actual PBT performance includes the adjustment to reported PBT as described above. We have included details of the performance achieved against the non-financial measures to improve transparency for shareholders although some metrics remain commercially sensitive.

The bar chart illustrates the Committee's assessment of the level of achievement under the AIP. The outcomes reflect continuing strong performance during the year as discussed in the Group highlights and Chairman's statement on page 1 and pages 8 to 9 respectively.

Measures		Weight (as a % of max award)	Target performance (£m)	Actual performance (£m)	Performance assessment	Achievement against performance measures (0% Vesting; Target 60% Vesting; Maximum 100% Vesting)
Financial	Profit before tax	55%	479.3	605.1	Maximum	100%
Strategic	A basket of measures – key customer and people metrics	25%	See narrative		Above target	84%
Personal	Including objective shared among all Executive Committee members	20%	See narrative		On target	60%

Executive Director	Achievement under the 2017 AIP
Paul Geddes	88% of maximum
John Reizenstein	88% of maximum
Mike Holliday-Williams	88% of maximum
Penny James	88% of maximum

The Committee also considered performance against the "gateway" criteria outlined on page 91 and determined that it was appropriate to pay a bonus and that it was not necessary to reduce the payment in light of performance against these criteria.

Financial element (55% weighting)

As discussed above, there is no pre-set scale around the PBT target for the 2017 financial year and, in accordance with the AIP terms, the Committee determined the appropriate payout for the performance achieved. The outturn was 26% ahead of the target and, therefore, considerably ahead of the indicative maximum of 10% ahead of target resulting in a maximum payout for this element. As noted in the Chair's letter, PBT performance included the neutralisation of the capital transactions, which had no impact on the outturn.

Strategic element (25% weighting)

The Group's strategy is to make insurance much easier and better value for our customers. We have continued to invest in improving the customer experience and removing the reasons for customer problems. Overall, performance on the customer agenda against our 11 key customer metrics remains very strong, with the Direct Line and Churchill brands performing well in independent customer experience benchmarking studies and good progress on key Net Promoter Score measures and customer journeys.

2017 saw the introduction of a basket of people measures to the AIP scorecard to reflect the importance of this agenda to the success of the Group. Progress on these measures was also considered to be very strong, with key focus areas such as succession strength, diversity and employee engagement showing notable development.

The Committee considered that the Group has made good progress in continuing to improve the customer experience against an already solid performance, as well as advancements in its key people measures against a background of high employee engagement. Having considered performance against targets and an assessment of the quality of performance achieved, the Committee agreed an outturn of 84% under this element for this good performance.

Personal element (20% weighting)

This element relates to an objective that is shared with other Executive Committee members and set by the Committee. The Committee considers the performance against this element together with the Executive's personal performance and leadership over the year.

The Group remains focused on improving its digital offering, customer experience and operational efficiency, and a key focus of management continues to be the level of change the Group is making to its IT infrastructure. 2017 saw the Group make good progress on these plans, executing key planned changes on schedule, increasing confidence in future plans and managing costs, with a significant focus on the stability and security of the IT environment. Whilst there was significant progress on these initiatives, the impact on intangible assets due to a reworking of some elements of capital expenditure resulted in an impairment charge at the year end (and which is included in the outcome under the Financial element).

Taking performance against each Executive Director's individual performance objectives and the above challenges into account, the Committee determined that the Executive Directors should each receive awards of 60% of the maximum available under this element.

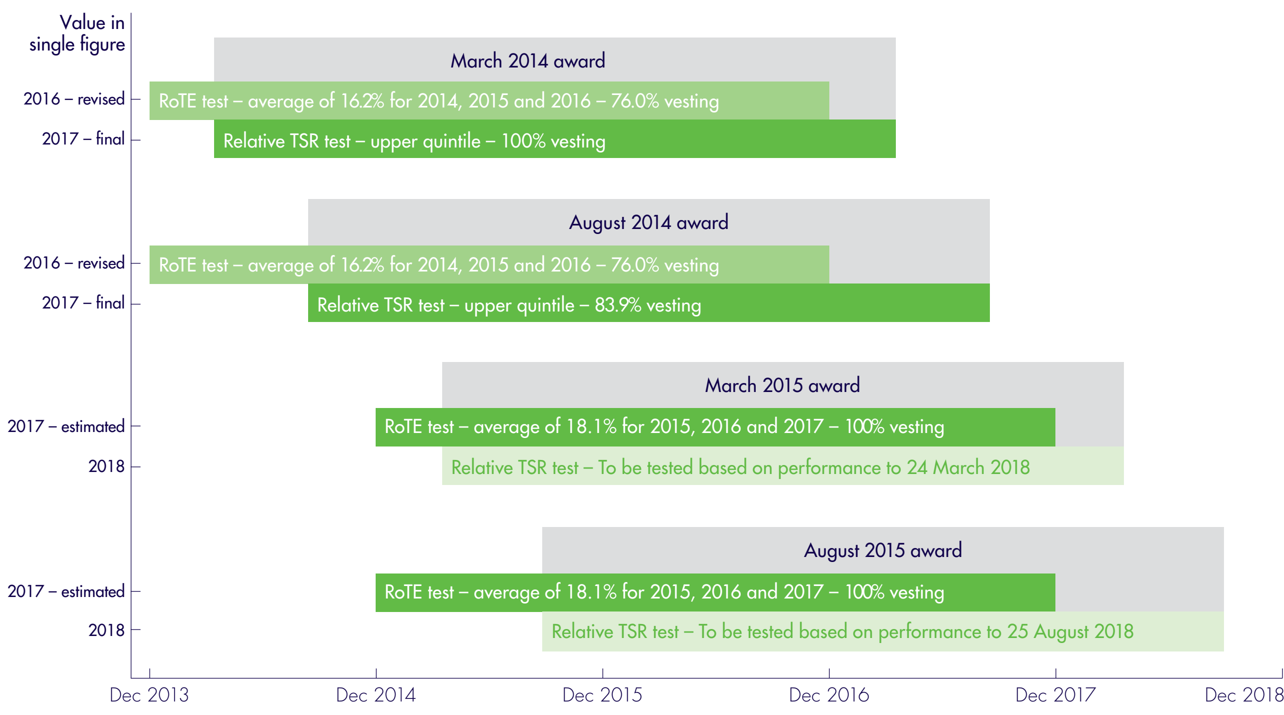
Consequently, the annual incentive awards for Executive Directors for the financial year ended 31 December 2017 were as follows:

(Audited)	Maximum (% of salary)	Target (% of salary)	Actual (% of salary)	Actual £'000 (including cash and deferred elements)
Paul Geddes, CEO	175%	105%	154%	1,242
John Reizenstein, CFO	150%	90%	132%	644
Mike Holliday-Williams, MD Personal Lines	150%	90%	132%	721
Penny James, CFO-designate[1]	175%	105%	154%	173

Note:
1. The annual incentive award made to Penny James represents a pro-rated amount for the period 1 November to 31 December 2017 since joining the Company.

LTIP outcomes for 2017 (Audited)

The following summarises the outcome against performance targets set for the 2014 and 2015 LTIP awards:



Awards under the LTIP granted in March and August 2014 vested during 2017. They were subject to TSR performance over the three-year vesting period, and RoTE performance in 2014, 2015 and 2016. The Group achieved an average RoTE of 16.2% over the three-year performance period. This resulted in 76% of the maximum potential vesting of the RoTE element (45.6% of the total award). The TSR element comprises the other 40% of the total award. For the March 2014 awards, the Company's TSR was positioned above upper quintile against its comparator group; for the August 2014 awards, TSR was slightly below the upper quintile. This resulted in 100% and 83.9% respectively of the maximum potential vesting under the TSR element (40% and 33.6% of the total award). Overall, 85.6% of the total awards vested in March 2017 and 79.2% in August 2017 as the Committee was satisfied that the financial and risk underpins were met at the end of the vesting period.

Awards under the LTIP granted in March and August 2015 are due to vest during 2018. This is subject to the Committee's satisfaction that the financial and risk underpins have been met at the end of the vesting period. The RoTE performance period for these awards ended on 31 December 2017. The three-year average RoTE performance for 2015, 2016 and 2017 was 18.1% against a maximum target of 17.5%. Awards under the RoTE element are due to vest at 100% of the maximum potential (60% of the total award). We have included these RoTE vesting outcomes plus the TSR vestings from the 2014 awards in the single remuneration figure for the CEO, the CFO and the MD Personal Lines. You can find details of this on page 79. Performance under the relative TSR measure will be assessed at the end of the vesting period in March and August as appropriate.

Non-Executive Directors (Audited)

Fees were the only remuneration paid to Non-Executive Directors in 2016 and 2017. Non-Executive Directors may also claim for reasonable travel and subsistence expenses, in accordance with the Group's travel and expenses policy, and, where these are classified as taxable by HMRC, they are shown under 'Benefits' below. The Non-Executive Directors receive no other benefits.

Director	2017 Fees[1] £'000	2017 Benefits[2] £'000	Total 2017 £'000	2016 Fees £'000	2016 Benefits £'000	Total 2016 £'000
Michael Biggs	400	6	406	400	3	403
Danuta Gray[3]	74	–	74	–	–	–
Jane Hanson	115	12	127	115	9	124
Sebastian James	90	–	90	89	–	89
Andrew Palmer	125	–	125	126	–	126
Clare Thompson	110	–	110	108	–	108
Richard Ward	115	–	115	106	–	106

Notes:
1. Non-Executive Directors are not eligible to participate in any of the Group's bonus or share incentive schemes or to join any Group pension scheme.
2. The values shown under 'Benefits' above comprise the value of taxable travel and subsistence expenses reimbursed by the Company (including any potential gross-up for tax and National Insurance Contributions due).
3. Danuta Gray was appointed to the Board from 1 February 2017. She was appointed to the Remuneration Committee with effect from 6 March 2017.

Percentage change in Chief Executive Officer's pay for 2016 to 2017

The table below shows the Chief Executive's year-on-year percentage change in salary, taxable benefits and bonus, compared to the average pay for all other UK employees.

	Salary[1]	Benefits[2]	Bonus (including deferred amount)[3,4]
Chief Executive Officer	2.0%	(4.3%)	109%
All employees (average)	3.3%	(5.1%)	22.7%

Notes:
1. Based on the change in average pay for UK employees employed in the year ended 31 December 2017 and the year ended 31 December 2016. Salaries are not adjusted for the number of working hours, therefore the increase partly reflects the increase in working hours for some employees during the year.
2. There were no changes in benefits provision between 2016 and 2017.
3. For employees other than the Chief Executive Officer, this includes average amounts earned under the AIP, and other variable incentive schemes, including monthly and quarterly incentive schemes operated in certain parts of the Group.
4. It should be noted that the bonus shows a high increase as the AIP was depressed in 2016 due to the significant reduction arising from the Ogden discount rate change. This remains subject to review if the rate is subsequently increased following the Government's review.

Chief Executive Officer's pay between 2012 and 2017

The table below shows historical levels of the Chief Executive Officer's pay between 2012 and 2017. It also shows vesting of annual and long-term incentive pay awards as a percentage of the maximum available opportunity.

Chief Executive Officer	Single figure of total remuneration £'000	Annual bonus payout (% of maximum)	Long-term incentive vesting (% of maximum)[1]
2017[2]	4,332	88%	99%
2016[3]	4,071	43%	86%
2015	4,795	83%	96%
2014	5,356	75%	88%
2013	2,536	63%	55%
2012	1,908	65%	30%

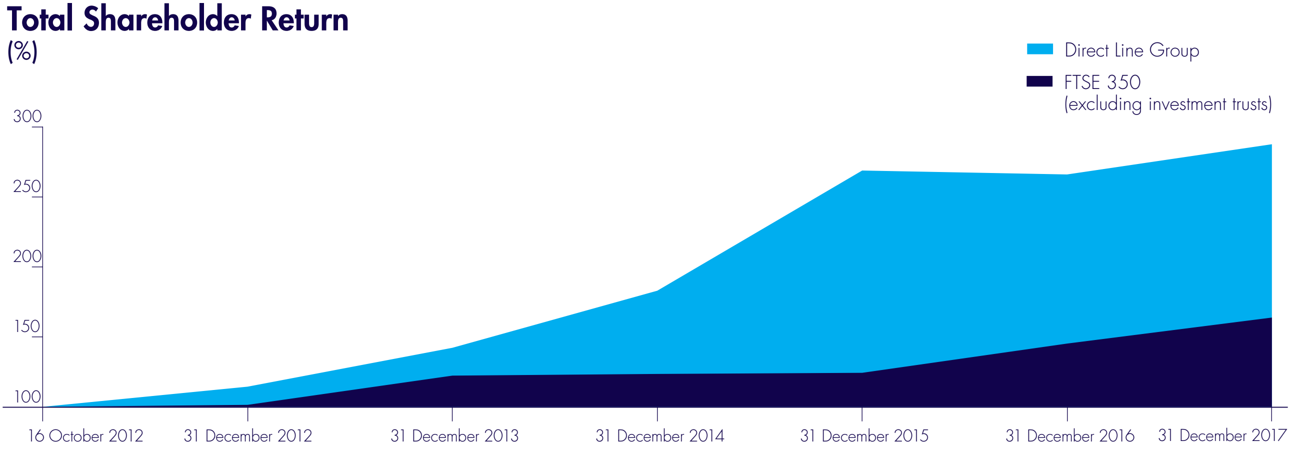
Notes:
1. Based on actual vesting under the 2010, 2011 and 2012 RBS Group LTIP. The value included in the single figures in respect of these awards is £205,000 in 2012, £728,000 in 2013 and £2,437,428 in 2014.
2. The 2017 single figure reflects the estimated vesting of the RoTE portion of the LTIP granted in March and August 2015. Any shares under the LTIP granted in 2015 will not be delivered until the end of the applicable vesting periods in March and August 2018. However, they have been included in the single figure, as the performance period in respect of the RoTE portion has now been completed.
3. The 2016 single figure has been revised to reflect the actual vesting of the 2014 awards under the LTIP, an increase of £4,855.

Historical performance of TSR

This graph shows the Company's TSR since its shares began trading on the London Stock Exchange in October 2012, against the FTSE 350 Index (excluding investment trusts) over the same period. This peer group is the same used for measuring relative TSR under the LTIP.

Total Shareholder Return

(%)



Distribution statement

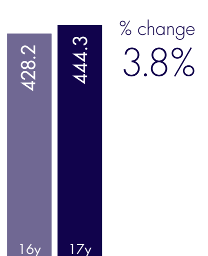
This chart shows the overall pay expenditure across all Group employees compared with the total dividend value paid to shareholders for 2016 and 2017.

Dividend (£m)

257.5
193.1
225.3
16y
17y

% change
-50%

Overall expenditure on pay (£m)



Note:
There were no special dividends paid in 2017 which reflected the Group's capital position following the implementation of the new Ogden Discount Rate at the beginning of the year. Furthermore, the Group implemented a new policy with regards to capital distributions in 2017 whereby the Board will consider whether or not it is appropriate to pay a special dividend once a year, alongside the full-year results. There have been no share buy-backs since the IPO. The overall expenditure on pay has been taken from note 10 to the consolidated financial statements. Therefore, consistent with market practice, it has not been calculated in a manner consistent with the single figure in this report.

AGM voting outcomes

The table shows the percentage of shareholders voting for or against, and the percentage of votes withheld, relating to the resolutions to approve the Directors' annual remuneration report and remuneration policy, both of which were put to shareholders at the 2017 AGM.

	For		Against		Number of votes withheld (abstentions)	Percentage of votes withheld (abstentions)
	Number	Percentage	Number	Percentage		
Approval of Directors' remuneration report (2017 AGM)	916,037,366	99.32%	6,285,817	0.68%	6,738,340	0.73%
Approval of Directors' remuneration policy (2017 AGM)	881,046,703	98.29%	15,349,348	1.71%	32,669,059	3.52%

Note:
The percentages of votes for and against are expressed as a percentage of votes cast, excluding votes withheld. The percentage of votes withheld is expressed as a percentage of total votes cast, including votes withheld. The Committee is grateful for the strong vote in favour of the Directors' annual remuneration report and remuneration policy in 2017. The Committee makes itself available to investors to discuss developments in the remuneration aspects of corporate governance generally, and, in particular, changes to the Company's executive pay arrangements.

Shareholdings

This table sets out the share ownership guidelines and share ownership levels:

Position	Share ownership guideline[1] (% of salary)	Value of shares held at 31 December 2017[2] (% of salary)
Chief Executive Officer	200%	456%
Chief Financial Officer	200%	756%
MD Personal Lines	200%	195%
Chief Financial Officer-designate	200%	77%

Notes:
1. Executive Directors are expected to retain all the Ordinary Shares they obtain from any of the Company's share incentive plans until they achieve a shareholding level that is equal to 200% of base salary. This is calculated after any disposals necessary to pay personal taxes on acquiring such Ordinary Shares.
2. For these purposes, holdings of Ordinary Shares will be treated as including all vested but unexercised awards, or awards unvested but after the performance period in the holding period, valued on a basis that is net of applicable personal taxes.

Using shares

In receiving an award under the LTIP or DAIP, Executive Directors commit not to hedge their exposure to outstanding awards under these plans or in respect of shares they are reporting to the Company within their ownership for the purposes of any Share Ownership Guidelines. They also agree not to pledge as collateral their participation under any of the plans or any shares which they are required to hold in the Company for any purposes, including for Share Ownership Guidelines.

This table shows each Executive Director's total share interests.

			Share plan interests at 31 December 2017		Beneficial share interests	
Director	Share plan awards subject to performance conditions[1]	Share plan awards not subject to performance conditions[2]	Share plan interests vested but unexercised	Share plan interests exercised or released during the year[3,4,5]	Total at 31 December 2017[6,7]	Total at 31 December 2016
Paul Geddes	1,300,488	301,202	1,044	751,325	967,821	572,468
John Reizenstein	787,103	158,404	972,536	436,302	455,831	195,602
Mike Holliday-Williams	738,301	184,644	–	312,598	280,736	112,989
Penny James	1,174,768	–	–	–	135,983	–

Notes:
1. This relates to awards under the Direct Line Group LTIP made to date. As described on page 82, awards made under the Direct Line Group LTIP in March and August 2015 that are subject to the RoTE performance condition, measured to 31 December 2017, are due to vest at 100% of the maximum potential. These shares will be delivered to Executive Directors in March and August 2018. For Penny James this also relates to one-off awards pursuant to Listing Rule 9.4.2 as disclosed on page 90.
2. Includes matching shares held under the SIP which are subject to forfeiture and deferred shares under the Direct Line Group DAIP. For more information, see pages 87 and 90.
3. On 27 March 2017 Paul Geddes exercised a DAIP and an LTIP award granted on 26 March 2014, and on 29 August 2017 exercised an LTIP award granted on 29 August 2014. Following these exercises, 1,044 DAIP shares remain vested but unexercised.
4. On 27 March 2017 John Reizenstein exercised a DAIP and an LTIP award granted on 26 March 2014, and on 29 August 2017 exercised an LTIP award granted on 29 August 2014. Following these exercises, 94,009 DAIP shares and 878,527 LTIP shares remain vested but unexercised.
5. On 4 May 2017 Mike Holliday-Williams exercised an RSP award granted on 27 May 2014, and on 29 August 2017 exercised an LTIP award granted on 29 August 2014.
6. Includes holdings of connected persons, as defined in section 96B(2) of the Financial Services and Markets Act 2000, and free and partnership shares held under the SIP which are not subject to forfeiture and considered beneficially owned.
7. Beneficial share interests include partnership shares John Reizenstein purchased under the SIP and free shares held by the CEO and the CFO under the SIP. At 26 February 2018, the number of shares beneficially held by John Reizenstein has increased to 455,949. There was no change to the number of shares held by Paul Geddes.

The table shows the Non-Executive Directors' beneficial interests in the Company's shares.

Director	Shares held at 31 December 2017[1,2]	Shares held at 31 December 2016
Mike Biggs	–	–
Danuta Gray	10,000	–
Jane Hanson	26,190	26,190
Sebastian James	5,000	–
Andrew Palmer	10,475	10,475
Clare Thompson	40,128	38,378
Richard Ward	–	–

Notes:
1. There were no changes to the number of shares held by Directors between the year end and the date of this report.
2. Includes holdings of connected persons, as defined in section 96B(2) of the Financial Services and Markets Act 2000.

Direct Line Group share awards

Direct Line Group Deferred Annual Incentive Plan ("DAIP") awards (Audited)

This table details the awards made to the CEO, the CFO and the MD Personal Lines under the Direct Line Group DAIP

Grant date	Three-day average share price for grant of awards £	Face value of award £	No. of share options as at 1 January 2017	No. of share options granted during the year[1]	No. of share options vested during the year	No. of dividend shares acquired at vesting	No. of dividend shares added post vesting	No. of share options exercised[2,3]	No. of share options held at 31 December 2017	Vesting date
Paul Geddes										
28-Mar-13	2.0157	380,004	997	–	–	–	47	–	1,044	28-Mar-16
26-Mar-14	2.433667	333,999	125,804	–	125,804	44,568	–	170,372	–	26-Mar-17
25-Mar-15	3.3007	400,000	111,087	–	–	–	–	–	111,087	25-Mar-18
29-Mar-16	3.752	447,996	119,402						119,402	29-Mar-19
27-Mar-17	3.361667	237,715		70,713					70,713	27-Mar-20
			357,290	**70,713**	**125,804**	**44,568**	**47**	**170,372**	**302,246**	
John Reizenstein										
28-Mar-13	2.0157	137,999	89,828	–	–	–	4,181	–	94,009	28-Mar-16
26-Mar-14	2.433667	166,000	62,525	–	62,525	22,150	-	84,675	–	26-Mar-17
25-Mar-15	3.3007	207,200	57,542	–	–	–	–	–	57,542	25-Mar-18
29-Mar-16	3.752	240,800	64,179	–	–	–	–	–	64,179	29-Mar-19
27-Mar-17	3.361667	123,318		36,683					36,683	27-Mar-20
			274,074	**36,683**	**62,525**	**22,150**	**4,181**	**84,675**	**252,413**	
Mike Holiday-Williams										
25-Mar-15	3.3007	239,997	66,651	–	–	–	–	–	66,651	25-Mar-18
29-Mar-16	3.752	270,797	72,174	–	–	–	–	–	72,174	29-Mar-19
27-Mar-17	3.361667	154,030		45,819	–	–	–	–	45,819	27-Mar-20
			138,825	**45,819**	**0**	**0**	**0**	**0**	**184,644**	

Notes:
1. Awards are granted as nil-cost options.
2. Paul Geddes exercised on 27 March 2017 at £3.3434 resulting in an aggregate gain of £569,613.
3. John Reizenstein exercised on 27 March 2017 at £3.3412 resulting in an aggregate gain of £282,916.

Direct Line Group Long-Term Incentive Plan ("LTIP") awards (Audited)

This table details the Directors' interests in the Company's LTIP. For all LTIP awards, 20% of the awards granted would vest if the minimum performance was achieved.

Grant date	Three-day average share price for grant of awards £	Face value of award £	No. of options at 1 January 2017[1]	No. of options granted during the year[2]	No. of share options vested during the year[3]	No. of options lapsed for performance[4]	No. of dividend shares acquired at vesting[5]	No. of dividend shares added post vesting	No. of options exercised[6,7,8]	No. of options held at 31 December 2017	Vesting date
Paul Geddes											
26-Mar-14	2.433667	759,998	286,261	–	230,435	55,826	101,415	–	331,850	–	26-Mar-17
29-Aug-14	2.9020	759,999	240,064	–	171,745	65,421	77,358	–	249,103	–	29-Aug-17
25-Mar-15	3.3007	760,000	211,066	–	–	–	–	–	–	211,066	25-Mar-18
26-Aug-15	3.517	775,200	220,415	–	–	–	–	–	–	220,415	26-Aug-18
29-Mar-16	3.752	775,197	206,609	–	–	–	–	–	–	206,609	29-Mar-19
30-Aug-16	3.6833	794,598	215,730	–	–	–	–	–	–	215,730	30-Aug-19
27-Mar-17	3.361667	794,597	–	236,370	–	–	–	–	–	236,370	27-Mar-20
29-Aug-17	3.854	810,488	–	210,298	–	–	–	–	–	210,298	29-Aug-20
			1,380,145	**446,668**	**402,180**	**121,247**	**178,773**	**0**	**580,953**	**1,300,488**	
John Reizenstein											
07-Nov-12	1.96	460,000	285,961	–	–	–	–	13,310	–	299,271	09-Nov-15
28-Mar-13	2.0157	459,999	288,654	–	–	–	–	13,435	–	302,089	28-Mar-16
28-Aug-13	2.1564	459,999	264,840	–	–	–	–	12,326	–	277,166	28-Aug-16
26-Mar-14	2.433667	460,000	173,263	–	139,474	33,789	61,382	–	200,856	–	26-Mar-17
29-Aug-14	2.9020	459,999	145,301	–	103,950	39,597	46,821	–	150,771	–	29-Aug-17
25-Mar-15	3.3007	460,000	127,750	–	–	–	–	–	–	127,750	25-Mar-18
26-Aug-15	3.5170	469,200	133,409	–	–	–	–	–	–	133,409	26-Aug-18
29-Mar-16	3.7520	469,199	125,053	–	–	–	–	–	–	125,053	29-Mar-19
30-Aug-16	3.6833	480,899	130,562	–	–	–	–	–	–	130,562	30-Aug-19
27-Mar-17	3.361667	480,900	–	143,054	–	–	–	–	–	143,054	27-Mar-20
29-Aug-17	3.854	490,518	–	127,275	–	–	–	–	–	127,275	29-Aug-20
			1,674,793	**270,329**	**243,424**	**73,386**	**108,203**	**39,071**	**351,627**	**1,665,629**	

Grant date	Three-day average share price for grant of awards £	Face value of award £	No. of options at 1 January 2017[1]	No. of options granted during the year[2]	No. of share options vested during the year[3]	No. of options lapsed for performance[4]	No. of dividend shares acquired at vesting[5]	No. of dividend shares added post vesting	No. of options exercised[6,7,8]	No. of options held at 31 December 2017	Vesting date
Mike Holliday-Williams											
29-Aug-14	2.9020	787,498	248,750	–	177,958	67,789	80,157	–	258,115	–	29-Aug-17
25-Mar-15	3.3007	393,747	109,351	–	–	–	–	–	–	109,351	25-Mar-18
26-Aug-15	3.5170	393,749	111,956	–	–	–	–	–	–	111,956	26-Aug-18
29-Mar-16	3.7520	393,750	104,944	–	–	–	–	–	–	104,944	29-Mar-19
30-Aug-16	3.6833	403,572	109,568	–	–	–	–	–	–	109,568	30-Aug-19
27-Mar-17	3.361667	538,099	–	160,069	–	–	–	–	–	160,069	27-Mar-20
29-Aug-17	3.854	548,860	–	142,413	–	–	–	–	–	142,413	29-Aug-20
			684,569	302,482	177,958	67,789	80,157	0	258,115	738,301	
Penny James[9]											
28-Nov-17	3.5673	1,349,984	–	378,433	–	–	–	–	–	378,433	28-Nov-20
			0	378,433	0	0	0	0	0	378,433	

Notes:
The Company's share price on 29 December 2017 was £3.817, and the range of prices in the year was £3.338 to £4.113.

1. These awards take the form of nil-cost options over the Company's shares and are subject to performance conditions to be assessed by the Committee. Awards granted before 2014 accrue dividend entitlements until the date of transfer of shares. Awards granted from 2014 accrue dividend entitlement from the grant date to the date on which an award vests.
2. The RoTE targets for awards granted in 2017, applying to 60% of the award, were 15% for 20% vesting, 16% for 40% vesting and 18% for full vesting. A straight-line interpolation occurs from threshold to target, and then from target to maximum performance. The remaining 40% of each award is based on TSR performance conditions, which are the same as noted on page 92.
3. The closing market price on the dates of the vesting of the awards was £3.368 on 27 March 2017 and 3.819 on 29 August 2017.
4. Awards under the LTIP vested at 85.6% of the maximum potential on 27 March 2017 and 79.2% of the maximum potential on 29 August 2017.
5. Dividends added post-vesting are shown to 31 December 2017, although these are not realised until exercise.
6. Paul Geddes exercised on 27 March 2017 at £3.3412 resulting in an aggregate gain of £1,108,777, and on 29 August 2017 at £3.8019 resulting in an aggregate gain of £947,065.
7. John Reizenstein exercised on 27 March 2017 at £3.3412 resulting in an aggregate gain of £671,100, and on 29 August 2017 at £3.8019 resulting in an aggregate gain of £573,216.
8. Mike Holliday-Williams exercised on 29 August 2017 at £3.8019 resulting in an aggregate gain of £981,327.
9. A full year's award to a total face value of 200% of base salary was made to the CFO-designate on 28 November 2017 as agreed as part of the remuneration package offered on recruitment. The award is subject to the same performance conditions as awards made to the other Executive Directors earlier in the year (except that TSR will be measured over the three years commencing on the date of grant).

Awards made in August and November 2017 also include an additional two-year holding period before awards may be released. The Company's normal policy is to grant awards twice a year, after the Group announces its full and half-year results. The value of each grant of awards is set at 50% of the annual policy level. This means the total combined face value of awards to each of the Executive Directors equates to 200% of base salary.

Buy-out awards (Audited)

The table below details the last tranche of the award made to Mike Holliday-Williams under the Direct Line Group Restricted Shares Plan (RSP) that vested in 2017. This award was made to the MD Personal Lines on recruitment in May 2014 as compensation for the forfeiture of legacy awards granted by his previous employer. Executive Directors do not participate in the RSP and Mike Holliday-Williams will not receive any subsequent grants under this plan.

Grant date	Three-day average share price for grant of awards £	Face value of award £	No. of share options as at 1 January 2017	No. of share options vested during the year	No. of dividend shares acquired at vesting	No. of share options exercised	No. of share options held at 31 December 2017	Vesting date
Mike Holliday-Williams								
27-May-14	2.430333	106,667	40,231	40,231	14,252	54,483	–	1-May-17

Note:
1. Mike Holliday-Williams exercised on 4 May 2017 at £3.5752 resulting in an aggregate gain of £194,788.

This table details buy-out awards made to Penny James. These awards were made to the CFO-designate in November 2017 as compensation for the forfeiture of legacy awards granted by her previous employer. The awards were made in the form of restricted stock options and are subject to performance conditions that, as far as possible, mirror those of the original awards. Performance will be assessed as soon as possible after the normal vesting date and following publication of the performance outturn over the relevant performance period. The awards will accrue dividend equivalent shares until vesting, as per the terms of the legacy awards.

Grant date	Three-day average share price for grant of awards £	Face value of award £	No. of share options granted	No. of dividend shares acquired at vesting	No. of dividend shares added post vesting	No. of share options exercised	No. of share options held at 31 December 2017	Vesting date
Penny James								
28-Nov-17	3.5673	500,492	140,298	–	–	–	140,298	3-April-18
Penny James								
28-Nov-17	3.5673	2,340,304	656,037	–	–	–	656,037	1-April-19

For the details of the performance conditions for each award see page 92.

Direct Line Group 2012 Share Incentive Plan ("SIP") (Audited)

During 2017, all employees, including Executive Directors, were eligible to invest from £10 to £150 a month from their pre-tax pay into the scheme, and receive one matching share for every two shares they purchased. This table details the number of shares held by John Reizenstein under the SIP. Paul Geddes, Mike Holliday-Williams and Penny James do not participate in the plan.

Director	Matching shares granted during the year	Matching shares cancelled during the year	Value of matching shares granted[1] £	Balance of matching shares at 31 December 2017
John Reizenstein	252	–	898	742

Note:
1. The accumulated market value of matching shares at the time of each award. Purchase of the matching shares takes place within 30 days of the contributions being deducted from salary.

Dilution

The Company complies with the dilution levels that the Investment Association guidelines recommend. These levels are 10% in 10 years for all share plans and 5% in 10 years for discretionary plans. This is consistent with the rules of the Company's share plans.

Statement of policy implementation in 2018

Executive Directors' salaries in 2018

The salary increase awarded to the Executive Directors, effective 1 April 2018, reflects the average increase awarded to staff generally.

Director	Position	2018 base salary £'000	2017 base salary £'000	Annual change in base salary
Paul Geddes	Chief Executive Officer	831	810	2.5%
John Reizenstein	Chief Financial Officer	491	491	–
Mike Holliday-Williams	MD Personal Lines	563	549	2.5%
Penny James	Chief Financial Officer-designate	675	675	–

AIP 2018

Director	Position	Maximum annual incentive award for 2018 (% base salary)	Deferred under |the DAIP (% bonus)
Paul Geddes	Chief Executive Officer	175%	40%
John Reizenstein	Chief Financial Officer	150%	40%
Mike Holliday-Williams	MD Personal Lines	150%	40%
Penny James	Chief Financial Officer-designate	175%	40%

The AIP measures remain unchanged:

	Measures	Weighting for 2018	Weighting for 2017
Financial	Profit before tax	55%	55%
Strategic	Based on a basket of: • customer measures, including Net Promoter Score and complaints; and • people measures, including measures of gender diversity and engagement	25%	25%
Personal	Objectives for each Executive Director, including shared objectives across the Executive Committee	20%	20%

As in previous years, all AIP outcomes will be determined after the Committee establishes a payment gateway. To do this, the Committee must be satisfied that it is appropriate to permit a bonus award at all, or at a given level. The gateway involves some subjectivity about performance. This may result in positive or negative moderation of each AIP performance measure or the overall bonus outcome. The targets are commercially sensitive and will be reported in next year's report.

The list below sets out the gateway criteria for the AIP for 2018.

Gateway criteria for the AIP for 2018 – outcomes for Executive Directors

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

The Committee may also use its discretion to account for additional factors. These include the quality of financial results, the 'direction of travel' of all measures, and, more widely, reputation, risk and audit.

In considering such factors, and whether to adjust the overall payouts and/or operate malus and clawback, the Committee receives appropriate input from the Audit Committee and the Board Risk Committee.

Performance conditions for LTIP awards

LTIP awards to be granted in 2018 will continue to be subject to performance against these performance conditions:

- 60% based on RoTE over a three-year performance period (2018, 2019 and 2020)
- 40% based on relative TSR performance against the constituents of the FTSE 350 (excluding investment trusts) over a three-year performance period, starting on the date of grant. The starting and closing TSR will be averaged over a three-month period

For these purposes, we use the Group's standard definition for RoTE, subject to such other adjustments as the Committee may consider appropriate. To find out more about how we calculate RoTE, see page 175.

The Committee reviewed the performance targets and, in line with its commitment to both reflect the impact of the capital transactions and to ensure that awards to Executive Directors would only be payable if significant value has been created for shareholders, decided to increase the RoTE target range as follows:

		Performance required for threshold vesting			Performance required for maximum vesting		
Performance measure	Vesting for threshold performance	Awards in 2018	Awards in 2017	Awards in 2015 and 2016	Awards in 2018	Awards in 2017	Awards in 2015 and 2016
RoTE	20% of this element of the award	Average annual RoTE performance of 17.5%	Average annual RoTE performance of 15.0%	Average annual RoTE performance of 14.5%	Average annual RoTE performance of 20.5%	Average annual RoTE performance of 18.0%	Average annual RoTE performance of 17.5%
Relative TSR	20% of this element of the award		Median			Upper quintile	

For the TSR element, there is a straight-line interpolation between threshold and maximum performance on a ranked basis.

For the RoTE element, 20% of the award will vest for threshold RoTE and 40% for a RoTE of 18.5% for awards to be made in 2018. Otherwise, vesting is similar to TSR: a straight-line interpolation occurs from threshold to target, then from target to maximum performance.

The LTIP awards will also vest only to the extent that the Committee is satisfied that the outcome of the TSR and RoTE performance conditions reflects the Group's underlying financial performance from the date of grant until vesting. When considering these matters, the Committee will also consider whether there have been any material risk failings.

Pension and benefits

A pension contribution of 25% of base salary will be paid to the CEO, CFO and CFO-designate in 2018. Before his promotion to the Board in 2017, the MD Personal Lines received a pension contribution of 15% of base salary and the level of contribution has not been changed following his appointment to the Board. No Directors participate in any defined benefit pension arrangements operated by the Company.

Benefits comprise providing a company car or car allowance, private medical insurance, life assurance, income protection and health screening. Like all employees, the Executive Directors are also eligible for certain discounted Group products.

New Executive Director

On 1 November 2017, Penny James joined the Board as an Executive Director and was appointed CFO-designate to succeed John Reizenstein. Penny's annual salary is £675,000 with a pension allowance of 25% of salary. She also participates in the Company's Annual Incentive Plan up to a maximum of 175% of salary and the Long-Term Incentive Plan up to 200% of salary.

As explained in the letter from the Committee Chairman, this did not reflect any increase on her package from her previous employer.

On joining she received an LTIP award over 200% of salary on the same terms as the August 2017 grant (except that the vesting dates will run from the date of grant). This was granted at the annual award level as no separate buy-out was made to compensate her for the loss of her 2017 award at her previous employer.

In addition, and as disclosed on page 90, she received one-off awards pursuant to Listing Rule 9.4.2 to compensate for the loss of LTIP awards made by her former employer. Performance conditions and comparator groups for these awards will be identical to those of the original LTIPs, save for the award which vests in 2019 where DLG's TSR performance will replace that of the former employer for the period from 1 November 2017 to 31 December 2018 (post-joining).

Full details of the awards bought out are set out in the relevant section above.

Penny James will also receive an amount in lieu of forfeited bonus opportunity at her previous employer for the period 1 January 2017 to 31 October 2017 and the single figure disclosures on page 79 have included an estimated amount of £840,841. This will only be paid once the Committee has finally determined the amount due. Any change to the estimated amount will be reported in next year's report. The award will be subject to deferral in line with the Group's deferral schedule which is the same as that of the original award.

Change of Executive Director

John Reizenstein, the current CFO, will be retiring in September 2018. He will not seek re-election at the Company's 2018 Annual General Meeting and will accordingly step down from the Board as an Executive Director at that time. The Committee confirmed his "good leaver" status without the use of any discretion. He will, therefore, retain awards granted to him up to the date on which his planned retirement was announced in September 2017 (for details of all awards see pages 87 and 88). John will also be eligible for an award under the AIP for the period to the AGM in May 2018 and will thereafter receive base salary and benefits only until the date of his actual retirement. No salary increase has been given for 2018.

Non-Executive Directors' fees

Position	Fees for 2018 £'000
Board Chairman fee	400
Basic Non-Executive Director fee	75
Additional fees	
Senior Independent Director fee	30
Chair of Audit, Board Risk and Remuneration Committees	30
Chair of CSR and Investment Committees	10
Member of Board Committee (Audit, Board Risk or Remuneration)	10
Member of Board Committee (CSR or Nomination)	5

No additional fees are paid for membership of the Investment Committee.

External directorships

Paul Geddes is a Non-Executive Director for Channel 4 for which he receives an annual fee of £22,177. John Reizenstein is a trustee and Director of Farm Africa, for which he receives no fees. Otherwise, the Executive Directors do not currently hold any further external directorships.

Service contracts

Subject to the discretion set out in the recruitment remuneration policy, it is the Company's policy to set notice periods for Executive Directors of no more than 12 months (both by the Director or Company). The Executive Directors' service agreements summary is as follows:

Director	Effective date of contract	Notice period (by Director or Company)	Exit payment policy
Paul Geddes	1 September 2012	12 months	Base salary only for unexpired portion of notice period to be paid in a lump sum or monthly instalments, in which case, instalments are subject to mitigation if an alternative role is found.
John Reizenstein	1 September 2012		
Mike Holliday-Williams	30 January 2014		
Penny James	1 November 2017		

There are no further obligations which could give rise to a remuneration or loss of office payment other than those set out in the remuneration policy and the termination policy.

The Chairman and Non-Executive Directors have notice periods of three months from either party which do not apply in the case of a Director not being re-elected by shareholders or retiring from office under the Articles of Association. Other than fees for this notice period, the Chairman and Non-Executive Directors are not entitled to any compensation on exit.

The Board reviewed and approved this report on 26 February 2018.

Clare Thompson
Chair of the Remuneration Committee

Policy report

The following is a copy of the main table from the policy approved by shareholders at the 2017 AGM. The full policy is available in last year's report.

Policy table

Element	Purpose and link to strategy	Operation
Base salary	• This is the core element of pay that reflects the individual's role and position within the Group. It is payable for doing the expected day-to-day job • Staying competitive in the market allows us to attract, retain and motivate high-calibre executives with the skills to achieve our key aims while managing costs	• Base salaries are typically reviewed annually and set in April of each year, although the Committee may undertake an out-of-cycle review if it determines this to be appropriate • When reviewing base salaries, the Committee typically takes the following into account: – level of skill, experience and scope of responsibilities, individual and business performance, economic climate, and market conditions; – the median market pay in the context of companies of a similar size, particularly FTSE 31-100 companies, as they are considered to reflect the size and complexity of the Group; – the practice of insurance peers such as Admiral Group, Aviva, esure Group, Hastings Group, Legal & General, Old Mutual, Phoenix Group, Prudential, RSA Insurance Group, Standard Life and companies of a similar size to DLG as appropriate; and – general base salary movements across the Group • The Committee does not follow market data strictly. However, it uses it as a reference point in considering, in its judgement, the appropriate salary level, while regarding other relevant factors, including corporate and individual performance, and any changes in an individual's role and responsibilities • The principles for setting base salary are similar to those applied to other employees in the Group. However, the specific benchmarking groups used to review external market relativities may differ across employee groups • Base salary is typically paid monthly
Pension	• To remain competitive within the market place • To encourage retirement planning and retain flexibility for individuals	• Pension contributions are paid only in respect of base salary • Executive Directors are eligible to participate in the defined contribution pension arrangement or alternatively they may choose to receive a cash allowance in lieu of pension
Benefits	• A comprehensive and flexible benefits package is offered, emphasising individuals being able to choose the combination of cash and benefits that suits them	• Executive Directors receive a benefits package generally set by reference to market practice in companies of a similar size and complexity, particularly FTSE 31-100 companies. Benefits currently provided include a company car or car allowance, private medical insurance, life insurance, health screening and income protection • The Committee may periodically amend the benefits available to some or all employees. The Executive Directors are eligible to receive such additional benefits as the Committee considers appropriate having regard to market norms • In line with our approach to all employees, certain Group products are offered to Executive Directors at a discount • Executive Directors are eligible to participate in any of the employee share plans operated by the Company, in line with HMRC guidelines (where relevant) and on the same basis as other eligible employees. Currently, this includes the Share Incentive Plan ("SIP"), which has been used to provide an award of free shares to all employees (including Executive Directors), and permit employees to purchase shares with a corresponding matching award • Where an Executive Director is required to relocate to perform their role, they may be offered appropriate relocation benefits. The level of such benefits would be determined based on the circumstances of the individual and typical market practice

Maximum opportunity	Performance measures
• When determining salary increases, the Committee will consider the factors outlined in this table under 'Operation'. In any event, no increase will be made if it would take an Executive Director's salary above £850,000 (the current median level of salaries for CEOs in the FTSE 100), as further increased by UK RPI from the date of approving this policy	• Not applicable
• The maximum pension contribution is set at 25% of base salary per annum	• Not performance-related
• The costs of benefits provided may fluctuate from year to year, even if the level of provision has remained unchanged. An annual limit of 10% of base salary per Executive Director has been set for the duration of this policy (plus an additional amount of up to 100% of salary in respect of relocation expenses). The Committee will monitor the costs in practice and ensure the overall costs do not increase by more than the Committee considers to be appropriate in all the circumstances • Additionally, the limit for any employee share plans in which the Executive Directors participate will be in line with the caps permitted by HMRC from time to time • The Executive Directors may be entitled to retain fees received for any directorships held outside the Group • Similarly, while not benefits in the normal usage of that term, certain other items such as hospitality or retirement gifts may also be provided	• Not performance-related

Element	Purpose and link to strategy	Operation
AIP	• To motivate executives and incentivise delivery of performance over a one-year operating cycle, focusing on the short- to medium-term elements of our strategic aims	• For Executive Directors, at least 40% of the award is deferred into shares under the Deferred Annual Incentive Plan (the "DAIP"). This typically vests three years after grant (with deferred awards also capable of being settled in cash at the discretion of the Committee, for example, when it gives rise to legal difficulties to settle in shares). The remainder of the award is paid in cash following the year end • The Committee will keep the percentage deferred and terms of deferral under review. This will ensure levels are in line with regulatory requirements and best practice and may be changed in future years but will not, in the Committee's view, be changed to be less onerous overall • Malus and clawback provisions apply to the cash and deferred elements. These are explained in the notes to the policy table
LTIP	• Aligning executives' interests with those of shareholders to motivate and incentivise delivering sustained business performance over the long term • To aid retaining key executive talent long-term	• Awards will typically be made in the form of nil-cost options or conditional share awards, which vest to the extent performance conditions are satisfied over a period of at least three years. Under the Plan rules, awards may also be settled in cash at the discretion of the Committee. This may be appropriate, for example, if legal difficulties arise with settling in shares • Vested options will remain exercisable up to the tenth anniversary of grant • Malus and clawback provisions apply to the LTIP. These are explained in the notes to the policy table • Awards under the LTIP may be made at various times during the financial year. While the Committee reserves the right to do otherwise, the Committee's practice has been to make awards twice in each financial year, following the announcement of the Group's annual and half-year results • For awards made after adopting the new policy at the 2017 AGM, Executive Directors will be subject to an additional two-year holding period following the three-year vesting period, during which time awards may not normally be exercised or released. During the additional holding period the awards will continue to accrue dividends. Following the holding period awards will cease to accrue dividends if not exercised
Share ownership guidelines	• To align the interests of Executive Directors with those of shareholders	• Executive Directors are expected to retain all the ordinary shares vesting under any of the Company's share incentive plans, after any disposals for paying applicable taxes, until they have achieved the required shareholding level unless such earlier sale, in exceptional circumstances, is permitted by the Chairman

Maximum opportunity	Performance measures
• Maximum and target bonus levels for Executive Directors are set by taking into account annual bonus practice throughout the organisation and referring to practice at other insurance and general market comparators • The maximum bonus opportunity under the AIP is 175% of base salary per annum. The current maximum bonus opportunity applying for each individual Executive Director is shown in the statement of implementation of policy	• Performance over the financial year is assessed against performance measures which the Committee considers to be appropriate • These may be financial, non-financial (Group, divisional or business line) and individual. Each year, at least 50% of the bonus is based on financial measures. The remainder of the bonus may be based on a combination of strategic, shared and individual performance measures • The Committee sets targets at the beginning of each financial year • No more than 10% of the bonus is paid for threshold performance (30% of the bonus for the individual performance element). No more than 60% of the maximum opportunity pays out for target performance. However, the Committee retains flexibility to amend the payout level at different levels of performance for future bonus cycles. This is based on its assessment of the level of stretch inherent in the set targets, and the Committee will disclose any such determinations appropriately • Before any payment can be made, the Committee will perform an additional gateway assessment (including in respect of any risk concerns). This will determine whether the amount of any bonus is appropriate in view of facts or circumstances which the Committee considers relevant. This assessment may result in moderating (positively or negatively) each AIP performance measure, subject to the individual maximum bonus levels • The AIP remains a discretionary arrangement. The Committee reserves discretion to adjust the outturn (from zero to the cap), should it consider it appropriate
• The maximum LTIP award in normal circumstances is 200% of salary • Awards of up to 300% of base salary are permitted in exceptional circumstances, relating to recruiting or retaining an employee, as determined by the Committee	• The Committee will determine the performance conditions for each award made under the LTIP, measuring performance over a period of at least three years with no provision to retest • Performance is measured against targets set at the beginning of the performance period, which may be set by referring to the time of grant or financial year • Awards vest based on performance against financial and/or such other (including share return) measures, as set by the Committee, to be aligned with the Group's long-term strategic objectives • For awards to be granted in 2017, vesting will continue to be determined based on two measures: RoTE and relative TSR performance against the FTSE 350 (excluding investment trusts). The Committee may apply different performance measures and targets for future awards, provided not less than 50% of the award shall be subject to one or more financial measures, and not less than 25% shall be subject to a relative TSR measure • Awards will be subject to a payment gateway, such that the Committee must be satisfied that there are no material risk failings, reputational concerns or regulatory issues • Additionally, there is a financial underpin relating to the Committee's view of the Group's underlying financial performance for the TSR and RoTE (and any other) elements 20% of the award vests for threshold performance, with 100% vesting for maximum performance. The Committee reserves the right in respect of future awards to lengthen (but not reduce) any performance period and/or amend the terms of any holding period; however, there is no intention to reduce the length of the holding period
• 200% of salary for all Executive Directors • The Committee reserves the discretion to amend these levels in future years	• Not applicable

Updated performance scenarios

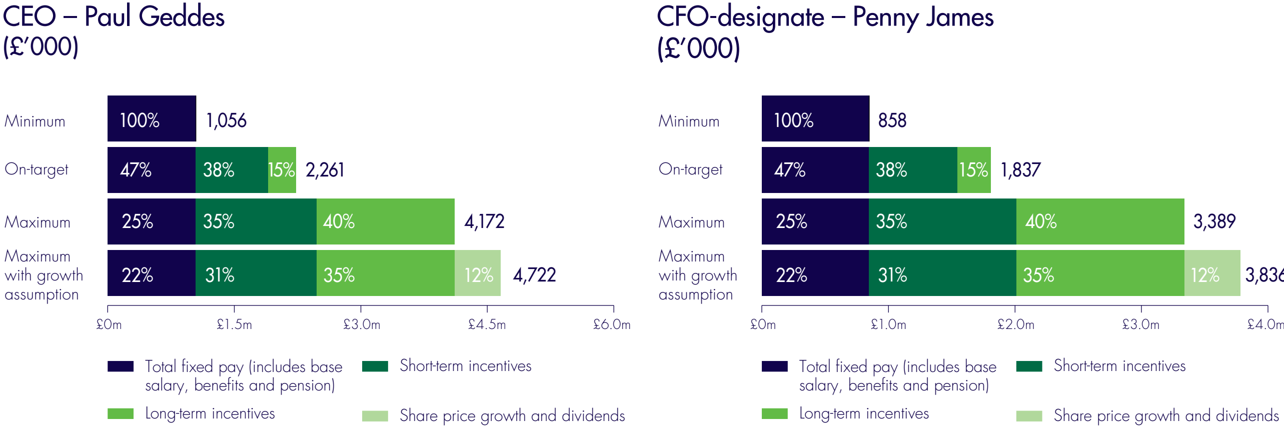
The Directors' remuneration policy has been designed to ensure that a significant proportion of total remuneration is delivered as variable pay and, therefore, depends on performance against our strategic objectives.

The Committee has considered the level of remuneration that may be paid under different performance scenarios to ensure it would be appropriate in each situation, in the context of the performance delivered and the value created for shareholders.

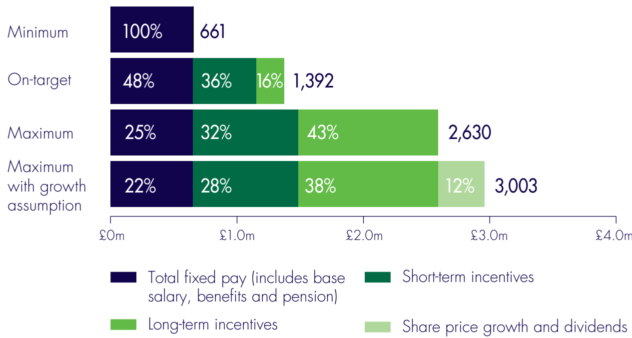
The following charts show the potential remuneration which Executive Directors may earn under four performance scenarios as set out below.

CEO – Paul Geddes (£'000)

CFO-designate – Penny James (£'000)



MD Personal Lines – Mike Holliday-Williams (£'000)



Note:
A chart for John Reizenstein has not been prepared on the basis that he will retire during the course of the year, will cease to be eligible for any AIP from the date of the AGM and will not receive a 2018 LTIP award.

The elements of remuneration included in each scenario are as follows:

Minimum	Consists of fixed remuneration only (base salary, benefits and pension): • Base salary is the salary to be paid from 1 April 2018 • Benefits measured as benefits paid in 2017 as set out in the single figure table on page 79, including the value of matching shares under the SIP where relevant • Pension measured as the defined contribution or cash allowance in lieu of Company contributions, as a percentage of salary (25% of base salary for the CEO and CFO-designate, and 15% of salary for the MD Personal Lines)
On-target	Based on what the Director would receive if performance was on-target (excluding share price appreciation and dividends): • Fixed remuneration as above • AIP – consists of the on-target bonus of 60% of maximum bonus opportunity • LTIP – consists of the threshold level of vesting (20% vesting)
Maximum	Based on the maximum remuneration receivable (excluding share price appreciation and dividends): • Fixed remuneration as above • AIP – consists of the maximum bonus (175% of base salary for the CEO and CFO-designate, and 150% for the MD Personal Lines) • LTIP – consists of the face value of awards (200% of base salary for all Executive Directors)
Maximum with growth assumption	To reflect the preference of some shareholders, this replicates the maximum assumptions above and also shows combined share price appreciation and dividend roll-up of 10% per annum over the three-year vesting period

The Directors present their report for the financial year ended 31 December 2017.

You can find the forward-looking statements disclaimer on page 180.

Strategic report

The Company's Strategic report is on pages 1 to 43. It includes the following information that would otherwise need to be disclosed in this Directors' report:

Subject	Pages
Use of financial instruments	40 and 41
Important events since the financial year end	8 to 11
Likely future developments in the business	11 and 43
Employee involvement	28 and 29

Corporate governance statement

The FCA's Disclosure Guidance and Transparency Rules require a corporate governance statement in the Directors' report to include certain information. You can find information that fulfils the corporate governance statement's requirements in this Directors' report; the Corporate Governance report; the Committee reports; and the Directors' remuneration report, on pages 44 to 99. This information is incorporated in the Directors' report by reference.

Disclosure of information under Listing Rule 9.8.4C

In accordance with Listing Rule 9.8.4C, the table below sets out the location of the information required to be disclosed, where applicable.

Subject	Page
Interest capitalised by the Group	None
Unaudited financial information	None
Long-term incentive plan involving one Director only	90
Directors' waivers of emoluments	None
Directors' waivers of future emoluments	Not applicable
Non pro-rata allotments for cash (issuer)	Not applicable
Non pro-rata allotments for cash (major subsidiaries)	None
Listed company is a subsidiary of another company	Not applicable
Contracts of significance involving a director	Not applicable
Contracts of significance involving a controlling shareholder	Not applicable
Details of shareholder dividend waivers	101
Controlling shareholder agreements	Not applicable

Dividends

The Group aims to manage its capital efficiently and generate long-term sustainable value for shareholders, while balancing operational, regulatory, rating agency and policyholder requirements.

The Group aims to grow its regular dividend in line with business growth.

Where the Board believes that the Group has capital which is expected to be surplus to the Group's requirements for a prolonged period, it would intend to return any surplus to shareholders. In normal circumstances, the Board expects that a capital coverage ratio around the middle of its risk appetite range of 140% to 180% of the Group's solvency capital requirement ("**SCR**") would be appropriate and it will therefore take this into account when considering the potential for special distributions.

In the normal course of events the Board will consider whether or not it is appropriate to distribute any surplus capital to shareholders once a year, alongside the full year results.

The Group expects that one-third of the annual dividend will generally be paid in the third quarter as an interim dividend, and two-thirds will be paid as a final dividend in the second quarter of the following year. The Board may revise the dividend policy from time to time. The Company may consider a special dividend and/or a repurchase of its own shares to distribute surplus capital to shareholders.

The Board recommends a final dividend of 13.6 pence per share to shareholders. Subject to shareholder approval at the Company's 2018 AGM, this will become payable on 17 May 2018 to all holders of Ordinary Shares on the Register of members at close of business on 6 April 2018. A special interim dividend has been declared of 15.0 pence per share and will have the same record and payment dates as the final dividend for 2017.

The final dividend resolution provides that the Board may cancel the dividend and, therefore, payment of the dividend at any time before payment, if it considers it necessary to do so for regulatory capital purposes. You can find detailed explanations about this in the Notice of AGM. The special interim dividend can also be cancelled if necessary.

You can find further details regarding dividends paid during 2016 and 2017 in the Finance review on page 39 and in note 14 to the consolidated financial statements on page 146. You can also find information on dividend capital management in the Finance review on page 42.

Directors

You can find the current Directors' biographies on pages 46 to 47. All Directors will retire and, excepting Messrs Palmer and Reizenstein, be submitted for election or re-election at the 2018 AGM. This is in accordance with the UK Corporate Governance Code and the Articles of Association of the Company, which govern appointing and replacing Directors. The Directors listed on pages 46 and 47 were the Directors of the Company throughout the year apart from Danuta Gray and Mike Holliday-Williams, who were each appointed as a Director on 1 February 2017, and Penny James, who was appointed as a Director on 1 November 2017.

The Company's Articles of Association set out the Directors' powers. You can view these on the Company's website at www.directlinegroup.com. The Directors' powers are also subject to relevant legislation and, in certain circumstances, authority from the Company's shareholders. You can find details of the Directors' remuneration, service contracts, employment contracts and interests in the shares of the Company in the Directors' remuneration report on pages 74 to 99.

The Articles of Association of the Company permit it to indemnify the Company's officers, and officers of any associated company, against liabilities arising from conducting Company business, to the extent permitted by law. As such, the Company has executed deeds of indemnity for each Director's benefit, regarding liabilities that may attach to them in their capacity as Directors of the Company or associated companies. These indemnities are qualifying third-party indemnities as defined by section 234 of the Companies Act 2006. No amount was paid under any of these indemnities during the year. The Company maintains directors' and officers' liability insurance. This provides appropriate cover for legal actions brought against its Directors. The Company has also provided the directors of DLG Pension Trustee Limited with qualifying pension scheme indemnities. This is in accordance with section 235 of the Companies Act 2006. DLG Pension Trustee Limited acts as trustee for two of the Company's occupational pension schemes.

Secretary

Roger Clifton is the Company Secretary of Direct Line Insurance Group plc. He can be contacted at the Company's Registered Office, details of which are on page 181.

Share capital

The Company has a premium listing on the London Stock Exchange. As at 31 December 2017, the Company's share capital comprised 1,375,000,000 fully paid Ordinary Shares of 10 10/11 pence each.

At the Company's 2017 AGM, the Directors were authorised to:

- allot shares in the Company or grant rights to subscribe for, or convert, any security into shares up to an aggregate nominal amount of £50,000,000;
- allot shares up to an aggregate nominal amount of £100,000,000, for the purpose of a rights issue;
- allot shares having a normal amount not exceeding in aggregate £15,000,000 for cash without offering the shares first to existing shareholders in proportion to their holdings; and
- make market purchases of up to 137,500,000 shares in the Company, representing 10% of the Company's issued share capital at the time.

To date, the Directors have not used these authorities. At the 2018 AGM, shareholders will be asked to renew these authorities and vote on some additional resolutions in relation to the disapplication of pre-emption rights in line with the most recent institutional investors' guidelines. The Company has not held any shares in treasury during the period under review. You can find out more about the Company's share capital and shares under option at 31 December 2017 in notes 29 and 35 to the consolidated financial statements.

Under the Company's Share Incentive Plan, Trustees hold shares on behalf of employee participants. The Trustees will only vote on those shares and receive dividends that a participant beneficially owns, in accordance with the participant's wishes. An Employee Benefit Trust also operates. The Trustee of this has discretion to vote on any shares it holds as it sees fit, except any shares participants own beneficially; in which case, the Trustee will only vote on such shares as per a participant's instructions.

The Trustee of this Trust has waived its right to dividends on all shares within the Trust. You can find out more about the number of shares held by the employee share plan trusts in note 29 on page 154. The Company is only aware of the dividend waivers and voting restrictions mentioned above.

Shareholder voting rights and restrictions on transfer of shares

All the Company's issued Ordinary Shares rank equally in all respects. The Company's Articles of Association set out the rights and obligations attaching to the Company's Ordinary Shares.

Employees in the Company and Directors must conform with the EU Market Abuse Regulation and the Company's share dealing rules. These rules restrict particular employees' and Directors' ability to deal in the Company's shares at certain times, and require the employee or Director to obtain permission to deal before doing so. Some of the Company's employee share plans also include restrictions on transferring shares while the shares are held within the plans.

Each general meeting notice will specify the time for determining a shareholder's entitlement to attend and vote at the meeting. This will not be more than 48 hours before the time fixed for the meeting. To be valid, all proxy appointments must be filed at least 48 hours before the time of the general meeting. In calculating this time period, no account shall be taken of any part of a day that is not a working day.

Where the Company has issued a notice under section 793 of the Companies Act 2006, which is in default for at least 14 days, the person(s) interested in those shares shall not be entitled to attend or vote at any general meeting until the default has been corrected or the shares sold.

There is no arrangement or understanding with any shareholder, customer or supplier, or any other external party, which provides the right to appoint a Director or a member of the Executive Committee, or any other special rights regarding control of the Company.

Articles of Association

Unless expressly specified to the contrary in the Articles of Association, they may only be amended by a special resolution of the Company's shareholders at a general meeting.

Significant agreements affected by a change of control

A number of agreements may take effect, alter or terminate upon a change of control of the Company. None of these agreements are considered significant in terms of their impact on the Group's business as a whole. All the Company's employee share incentive plans contain provisions relating to a change of control. Outstanding awards would typically vest and become exercisable. This is subject to satisfying any performance conditions, and normally with an additional time-based pro-rata reduction where performance conditions apply, and approval from the Remuneration Committee.

Substantial shareholdings

In accordance with the provisions of chapter 5 of the FCA's Disclosure Guidance and Transparency Rules, the Company has been notified of the following indirect interests in the Company's voting rights. The Company has not been notified of any direct interests. Information provided by the Company pursuant to the FCA's Disclosure Guidance and Transparency Rules is publicly available via the regulatory information services and on the Company's website.

	31 December 2017	26 February 2018
Artemis Investment Management LLP	5.60%	5.32%
BlackRock, Inc.	8.39%	9.30%
Standard Life Aberdeen plc	8.54%	8.49%

Political donations

The Group made no political donations during the year (2016: nil).

Employees with disabilities

The Group is committed to promoting diversity and inclusion across every area of the business through initiatives such as the Diversity Network Alliance. At recruitment, we adjust and enhance our application and selection process, and guide and provide additional training for interviewers, where necessary.

Our Diversity Network Alliance focuses on a number of strands including employees with disabilities. It identifies areas where we can improve and help people to continue working for us. We reasonably adjust employees' working environments and equipment, and roles and role requirements. We also ensure that everyone can access the same opportunities.

Greenhouse gas emissions

In order to comply with the Companies Act 2006 (Strategic and Directors' Report) Regulations 2013, the Group has followed the 2013 UK Government environmental reporting guidance for GHG emissions; used the UK Government's greenhouse gas conversion factors; and adopted the financial control approach to setting the organisational boundaries of responsibilities for GHG emissions. In applying the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) we have calculated emissions associated with electricity consumption using both the location-based Scope 2 and market-based Scope 2 calculation methodologies. GHG emissions are classified as direct or indirect, and divided into Scope 1, Scope 2 and Scope 3 emissions. Direct GHG emissions are those from sources that the Group owns or controls. Indirect GHG emissions are those that are a consequence of the Group's activities, but occur at sources owned or controlled by another organisation. The Group has considered the seven main GHGs, reported in tonnes of carbon dioxide equivalent ("**CO_2e**"), and set 2013 as the base year.

Scope 1 – direct emissions including fuels used in office buildings, accident repair centres and owned vehicles.

Scope 2 – indirect emissions resulting from generating electricity purchased for office buildings and accident repair centres.

Scope 3 – includes all other indirect emissions such as waste disposal, business travel and staff commuting.

Total GHG emissions (Scope 1 and Scope 2) for continuing operations for 2017 were 17,399 tonnes (2016: 19,315 tonnes), as set out in the table below. This primarily comprised emissions from purchased electricity and natural gas, diesel fuel, and refrigerant gas used. In addition to total emissions, the Group also monitors emissions per £ million of net earned premium. In 2017, this was 5.5 tonnes CO_2e per £ million of net earned premium for continuing operations (2016: 6.4 tonnes). This is a measure of how efficiently insurance products are provided. It allows us to compare our year-on-year performance and performance against other insurance companies. You can find verification statements on the Group's website at www.directlinegroup.com. You can find further information on the Group's approach to energy and the environment in the CSR section on page 29.

Global GHG emissions data for Reporting Year 1 January 2017 – 31 December 2017

Emissions from:	Scope 2 Location-based Tonnes of CO_2e	Scope 2 Market-based Tonnes of CO_2e
Combustion of fuel & operation of facilities (Scope 1)	8,027	8027
Electricity, heat, steam and cooling purchased for own use (Scope 2)	9,371	10,476
Total (Scope 1 & 2)	**17,399**	**18,503**
Intensity metric: tonnes CO_2e/Million GBP net earned premium (£m)	5.5	5.9
Transmission and Distribution ("**T&D**") losses from electricity (Scope 3)	876	876
Total (Scope 1, 2 & 3 – T&D Losses)	**18,275**	**19,379**
Intensity metric: tonnes CO_2e/Million GBP net earned premium (£m)	5.8	6.2
T&D losses from electricity, commuting, paper and business travel (Scope 3)	18,072	18,072
Total (Scope 1, 2 & 3)	**35,471**	**36,575**
Intensity metric: tonnes CO_2e/Million GBP net earned premium (£m)	11.3	11.6

Year on Year Comparison (Scope 2 Location-based methodology)	Tonnes of CO_2e			
Emissions from:	2013	2016	2017	Percentage change (2013 to 2017)
Scope 1	8,429	7,383	**8,027**	5%
Scope 2	21,480	11,932	**9,371**	56%
Total (Scope 1 & 2)	29,909	19,315	**17,399**	42%
Intensity metric: tonnes CO_2e/million GBP net earned premium (£m)	8.5	6.4	**5.5**	35%
Scope 3 (Only T&D losses from electricity)	1,774	1,079	**876**	51%
Total (Scope 1, 2 & 3 – T&D Losses)	31,683	20,394	**18,275**	42%
Intensity metric: tonnes CO_2e/Million GBP net earned premium (£m)	9.0	6.8	**5.8**	36%

Going concern

The Group has sufficient financial resources to meet its financial needs, including managing a mature portfolio of insurance risk. The Directors believe the Group is well-positioned to manage its business risks successfully in the current economic environment.

The Finance review on pages 42 and 43 describes the Group's capital management strategy, which covers how it measures its regulatory and economic capital needs, and deploys capital.

The Group's financial position is also covered in that section, including a commentary on cash and investment levels, reserves, currency management, insurance liability management, liquidity, and borrowings. Additionally, note 3 to the consolidated financial statements describes capital management needs and policies. The note also covers insurance, market, liquidity and credit risks which may affect the Group's financial position.

Having made due enquiries, the Directors reasonably expect that the Company and the Group have adequate resources to continue in operational existence for at least 12 months from 26 February 2018 – the date of approval of the financial statements. Accordingly, the Directors have adopted the going concern basis in preparing the financial statements.

Disclosing information to the Auditor

Each Director at the date of approving these Annual Report & Accounts confirms that: as far as they are aware, there is no relevant audit information of which Deloitte LLP, the Company's External Auditor, is unaware; and they have taken all the steps they ought to have taken as a Director to make themselves aware of any relevant audit information, and establish that Deloitte LLP is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Auditor

Deloitte LLP has expressed its willingness to continue in office as the External Auditor. A resolution to reappoint Deloitte LLP will be proposed at the forthcoming AGM. You can find an assessment of the effectiveness and recommendation for reappointing Deloitte LLP in the Audit Committee report on page 64.

Directors' responsibility statement

The Directors are responsible for preparing the Annual Report and financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare such financial statements for each financial year. Under that law, the Directors must prepare the Group financial statements in accordance with IFRS, as adopted by the EU and Article 4 of the International Accounting Standard ("IAS") regulation. The Directors have also chosen to prepare the Parent Company financial statements under IFRS, as adopted by the EU. Under company law, the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the Company's state of affairs and profit or loss for that period.

In preparing these financial statements, IAS 1 requires that Directors: properly select and apply accounting policies; present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and assess the Company's ability to continue as a going concern.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose, with reasonable accuracy, the Company's financial position at any time; and enable them to ensure the financial statements comply with the Companies Act 2006. Additionally, the Directors are responsible for safeguarding the Company's assets and, hence, taking reasonable steps to prevent and detect fraud and other irregularities. The Directors are responsible for maintaining and ensuring the integrity of the corporate and financial information included on the Company's website at www.directlinegroup.com. Legislation in the UK governing preparing and disseminating financial statements may differ from legislation in other jurisdictions.

Each of the Directors, whose names and functions are listed on pages 46 to 47, confirm that, to the best of their knowledge:

- the financial statements, prepared in accordance with IFRS, give a true and fair view of the assets, liabilities, financial position, and profit or loss of the Company and the undertakings included in the consolidation taken as a whole;
- the Strategic report (on pages 1 to 43) and Directors' report (on pages 100 to 103) include a fair review of: (i) the business's development and performance; and (ii) the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties they face; and
- the annual report and the financial statements, taken as a whole, are fair, balanced and understandable, and provide the information necessary for shareholders to assess the company's position and performance, business model and strategy.

The Board reviewed and approved this report on 26 February 2018.

By order of the Board

Roger C. Clifton
Company Secretary

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Independent Auditor's report to the shareholders of Direct Line Insurance Group plc

Opinion

In our opinion:

- The financial statements give a true and fair view of the Group's and Parent Company's affairs as at 31 December 2017, and of the Group's profit for the year then ended
- The Group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and IFRSs as issued by the International Accounting Standards Board (IASB)
- The Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and IFRSs as issued by the IASB and as applied in accordance with the provisions of the Companies Act 2006; and
- The financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation

The financial statements, included within the Annual Report and Accounts, comprise of:

- the Consolidated Income Statement
- the Consolidated and Parent Company Statements of Comprehensive Income
- the Consolidated and Parent Company Balance Sheets
- the Consolidated and Parent Company Cash Flow Statements
- the Consolidated and Parent Company Statements of Changes in Equity; and
- the related notes 1 to 41 on the Consolidated financial statements, and the related notes 1 to 18 on the Parent Company financial statements

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union and, with regards to the Parent Company's financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Group and the Parent Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that no non-audit services prohibited by the FRC's Ethical Standard were provided to the Group or the Parent Company.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were: • Valuation of insurance reserves 1) The frequency and severity of bodily injury excess claims 2) The inflation and discount rate assumptions for valuing PPOs • Valuation of intangible assets • Valuation of investments not held at fair value
Materiality	The materiality that we used for the Group financial statements was £28.0 million which approximates 5.2% of three year average profit before tax from Ongoing operations.
Scoping	Our Group audit scoping included two entities being subject to a full scope audit and a further two entities being subject to an audit of specified account balances. These four entities represent the principal business units and account for 99% of the Group's net assets, 100% of the Group's gross earned premium and 98% of the Group's profit before tax.
Significant changes in our approach	Last year our report included key audit matters relating to Change and IT and the setting of propensity and severity assumptions when valuing PPO liabilities. We determined that the scale of offshoring and outsourcing has not materially changed in the year, and the processes and controls that had been offshored or outsourced and the Group's oversight thereof were now embedded in the organisation. Following the Ogden discount rate change, the propensity and severity assumptions represented a reduced risk in comparison to previous audits. Through performing our detailed risk assessment for the 2017 audit, we refined our key audit matters to focus on inflation and discount rate assumptions when valuing PPOs and on the valuation of intangible assets.

Conclusions relating to going concern, principal risk and viability statements

Going concern

We have reviewed the Directors' statement on page 103 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's and Parent Company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We are required to state whether we have anything material to add or draw attention to in relation to that statement required by Listing Rule 9.8.6R(3) and report if the statement is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Principal risks and viability statement

Based solely on reading the Directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the Directors' assessment of the Group's and Parent Company's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on pages 24 and 25 that describe the principal risks and explain how they are being managed or mitigated
- the Directors' confirmation on page 57 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity; or
- the Directors' explanation on page 23 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions

We are also required to report whether the Directors' statement relating to the prospects of the Group required by Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon. We do not provide a separate opinion on these matters.

Valuation of insurance reserve

Refer to page 62 (Audit Committee Report), page 118 (accounting policies) and page 156 (financial disclosures).

The Group's insurance reserves total £4.2 billion (2016: £4.7 billion). The determination of the value of the insurance reserves requires significant judgement in the selection of key actuarial methodologies and assumptions. Small changes in these methodologies or assumptions can materially impact the valuation of these liabilities. We have identified the following two key areas of focus for our audit given their significance to the Group's result and the level of judgement involved. We have also identified these as potential fraud risk areas.

1) The frequency and severity of excess bodily injury claims;

Key audit matter description

The insurance reserve valuation for bodily injury excess claims has a significant impact on the Group's results, with the ultimate number of large bodily injury claims being inherently uncertain and driven by a number of factors. These include the completeness and accuracy of source data, the transparency of any changes in the reporting of excess claims, and actuarial assumptions being consistent with emerging data, internal processes and market factors.

Furthermore, the reduction in the Ogden discount rate to minus 0.75% in February 2017 has impacted on the historical consistency of bodily injury excess data by causing a "step-change" in incurred claims and potentially affecting claimant reporting behaviour. As typical actuarial techniques rely on the projection of historical data, this rate change increases the level of uncertainty in the Group's modelled reserves for bodily injury excess claims which increases the susceptibility of the balance to material misstatement due to error and fraud.

How the scope of our audit responded to the key audit matter
We have gained a detailed understanding of the end to end claims and reserving process, and assessed the design and implementation of selected controls. We have also tested the operating effectiveness for actuarial data reconciliations and key management review controls over the reserving process. Our work included attendance at the January Reserve Review Committee in order to observe a key management review control.

We have tested the completeness and accuracy of the underlying data used in the Group's actuarial calculations and the actuarial data used by Deloitte actuarial specialists by performing reconciliations on the data back to the financial ledger.

Having done this, we worked with those specialists to:

- assess and challenge the methodologies and key assumptions, and their underlying rationale, adopted by the Group
- review the estimated impact on reserves of recent paid and incurred claim developments using our in-house reserve software
- perform analytical procedures and diagnostic testing in challenging the reserving impact pre and post the change in Ogden discount rate; and
- inspect the Group's actuarial models and perform sensitivity testing and peer benchmarking on key assumptions

Key observations
We have determined the estimate for the ultimate value of large bodily claims to be reasonable. In making this determination we observed that the frequency and severity assumptions used in determining this ultimate value are reasonable, albeit slightly prudent.

2) **The inflation and discount rate assumptions for valuing PPOs**
Key audit matter description
The Group is required to settle a proportion of large bodily injury claims as PPOs rather than lump sum payments. The valuation of PPOs has a material impact on the financial statements, with these liabilities totalling £898.7 million (2016: £983.0 million) on a discounted gross basis as detailed in note 2. PPO liabilities are sensitive to the choice of inflation and discount rate used. These assumptions require significant management judgement which increases the susceptibility of the balance to material misstatement due to error and fraud.

How the scope of our audit responded to the key audit matter
We have gained a detailed understanding over the setting of these assumptions and assessed the design and implementation of key governance controls surrounding the setting of the PPO inflation rate and discount rate. In addition, we tested the operating effectiveness of a direct and precise business control, performed weekly, over the completeness of the PPO listing; this is a key data input which has a material impact on the PPO assumptions and hence the valuation.

We have worked with our actuarial specialists to:

- review and challenge the Group's PPO inflation assumption through inquiries with the Actuarial Director, reviewing relevant supporting documentation and benchmarking against market economic data
- review the Group's sensitivity testing on the PPO inflation assumption, requesting additional sensitivity testing from management where required
- review and challenge the selected discount rate with reference to current and future performance of the assets backing the PPO liabilities; and
- benchmark the selected discount rate against peers

Key observations
We have determined that the inflation and discount rate assumptions used in the calculation of the PPO claims reserve are in the middle of a reasonable range. Given the current low yield environment we determined that these assumptions continue to require close monitoring going forward.

Valuation of intangible assets

Refer to page 62 (Audit Committee Report), page 119 (accounting policies) and page 147 (financial disclosures).

Key audit matter description
The Group continues to invest in initiatives and systems with the aim of improving the customer experience, supporting growth and increasing efficiency. This investment spans policy, pricing, payment and other related data and digital systems across the business. Following the appointment of a system integrator during the year, the Group has decided to rework certain elements of the original capital expenditure already incurred on the assets, aimed at ensuring the initiatives achieve the targeted performance levels. Management identified this rework as an impairment indicator and performed a detailed review which resulted in an impairment charge of £56.9 million (2016: £39.3 million), bringing the valuation of intangible assets to £258.8 million (2016: £297.6 million).

In performing this impairment assessment, the assets were tested for impairment as part of the assets' cash generating unit ("CGU") in accordance with IAS 36 as the future cash flows will not be generated independently from the Motor, Home and Rescue and other personal lines CGUs. In addition, a significant level of judgement is required in determining the valuation of this impairment charge given the uncertainty over end-state system architecture and successful project delivery. As a result of these factors we identified the valuation of these intangible assets as a potential fraud risk.

How the scope of our audit responded to the key audit matter
We tested the design and implementation of key controls over the impairment of intangible assets. This included senior management review and approval of the impairment review and year end impairment charge.

In addition we performed the following audit procedures:

- we held inquiries with system consultants, inspected internal reports, system architecture maps and meeting minutes in order to challenge management on which components of the capital expenditure incurred to date will ultimately be used in the end-state system. We also engaged our IT consultants to assess the feasibility of the IT architecture in delivering the expected benefits across the Group
- we assessed whether the initiatives and systems under development are expected to generate cash flows independently from other groups of assets and the wider business. We performed an independent assessment of whether the future cash flows will be generated independently to evaluate the appropriateness of testing the asset as part of the asset's CGU; and
- we challenged management's forecasted future cash flows for each CGU through assessing historical forecasting accuracy, holding inquiries with management, inspecting the Group's five year strategic plan and benchmarking key assumptions against market data where applicable. We then engaged our valuation specialists to assess the appropriateness of the discount rate used in the value in use calculation

Key observations
We have determined that the £56.9 million impairment charge is reasonable.

While we observed that there is still uncertainty in the final end-state architecture design, based on the information available to date we deem the feasibility of successful project delivery and the expected benefits thereof to be reasonable.

We concurred with management that the asset's future cash flows will not be generated independently and the recoverable amount should therefore be tested as part of those CGUs. We observed that the forecasted future cash flows and the discount rate were reasonable and that no further impairment is required.

Valuation of investments not held at fair value

Refer to page 62 (Audit Committee Report), page 120 (accounting policies) and page 153 (financial disclosures).

Key audit matter description
We have identified a key audit matter for investments relating to the valuation of credit asset portfolios that are not held at fair value totalling £589.0 million (2016: £501.8 million) as detailed in note 26. Our work primarily focused on the Group's commercial real estate loan, infrastructure debt and private placement bond portfolios. These debt instruments are carried at amortised cost and represent a higher credit risk relative to the majority of DLG's investment portfolio.

During the year, the Group recognised an impairment provision totalling £9.5 million (2016: £nil) which arose from the cessation of interest on non-performing credit assets. Management judgement is required in determining if an incurred loss event has occurred and there is significant uncertainty in determining the fair value of the credit assets in the instance an event has occurred. As a result we identified the valuation of investments not held at fair value as a key audit matter.

How the scope of our audit responded to the key audit matter
We have assessed the design and implementation and tested the operating effectiveness of the key controls that mitigate the risk over the valuation of investments not held at fair value. Our work included attendance at the year-end impairment review meeting in order to observe the operation of a key management review control.

In addition we performed the following audit procedures:

- traced a sample of interest payments recognised to bank statements to test for default or delinquency in interest payments
- independently calculated the fair value for a sample of assets to identify any significant decreases in fair value below book cost; and
- challenged management on credit assets of interest where indicators could point to issuer financial difficulty, obtaining evidence to assess whether the position taken by management is reasonable

Key observations
We have determined that the £9.5 million impairment charge arising on non-performing credit assets is reasonable. In performing our procedures we did not note any other indicators of material impairment.

Our application of materiality

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

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Parent Company financial statements
Materiality	£28.0 million (2016: £28.0 million).	£25.2 million (2016: £25.2 million).
Basis for determining materiality	Materiality was determined as approximately 5.2% (2016: 5.6%) of average profit before tax from Ongoing operations, excluding the impact of the Ogden discount rate change on 2016 year end results.	Materiality was determined as less than 1% of shareholders' equity.
Rationale for the benchmark applied	We determined that the critical benchmark for the Group was average profit before tax from Ongoing operations. This measure uses a three-year average of profit before tax which we deemed appropriate due to the inherent volatility of profits in the insurance industry. We also elected to exclude the impact of the Ogden discount rate change on the 2016 results due to the non-recurring nature of this event. We also considered this measure to be suitable having compared to other benchmarks: our materiality equates to 5.1% (2016: 7.9%) of statutory profit before tax, 0.8% (2016: 0.9%) of gross earned premium and 1.1% (2016: 1.1%) of equity.	We determined that the critical benchmark for the Parent Company was shareholder's equity. This is because the Parent Company is not a trading entity but rather receives dividend income from its subsidiaries. When determining materiality for the Parent Company, we also considered the appropriateness of this materiality for the consolidation of this set of financial statements to the Group's results.

Group materiality is used for setting audit scope and the assessment of uncorrected misstatements. Materiality is set for each significant component in line with the components proportion of the chosen benchmark. This is capped at the lower of 90% of Group materiality and the component materiality determined for a standalone audit. The main UK insurance trading entity, U K Insurance Limited, which makes up 100% of Group gross earned premium and 94% of Group statutory profit before tax, is scoped to a component materiality of £25.2 million (2016: £25.2 million).

We determine performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed materiality for the financial statements as a whole. We have set Group performance materiality at £19.6 million (2016: £19.6 million) and the audit testing for UK Insurance Limited is carried out to a performance materiality of £17.6 million (2016: £17.6 million).

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £1.4 million (2016: £1.4 million) for the Group financial statements and £1.3 million (2016: £1.3 million) for the Parent Company financial statements, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

Independent Auditor's report to the shareholders of Direct Line Insurance Group plc
continued

An overview of the scope of our audit

The scope of our Group audit was determined by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the risks of material misstatement at the Group level.

This resulted in two entities being subject to a full scope audit, while a further two were subject to an audit of specified account balances where the extent of our testing was based on our assessment of the risks of material misstatement and of the materiality of the Group's operations. All entities within scope of the Group audit are based in the UK.

These four entities represent the principal trading and service operations of the Group and account for 99% (2016: 99%) of the Group's net assets, 100% (2016: 100%) of the Group's gross earned premium and 98% (2016: 98%) of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above.

At the parent entity level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specified account balances. The Group audit team also performs the audit of the in scope UK entities.

The Group audit team was responsible for all of the entities listed above, including the Parent Company.

Other information

We have nothing to report in respect of these matters

The Directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- Fair, balanced and understandable – the statement given by the Directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- Audit committee reporting – the section describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee; or
- Directors' statement of compliance with the UK Corporate Governance Code – the parts of the Directors' statement required under the Listing Rules relating to the company's compliance with the UK Corporate Governance Code containing provisions specified for review by the auditor in accordance with Listing Rule 9.8.10R(2) do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code

Responsibilities of Directors

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Directors are responsible for assessing the Group's and the Parent Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the Directors either intend to liquidate the Group or the Parent Company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Use of our report

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

Report on other legal and regulatory requirements

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the Directors' report have been prepared in accordance with applicable legal requirements

In the light of the knowledge and understanding of the Group and the Parent Company and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the Directors' report.

Matters on which we are required to report by exception

Adequacy of explanations and accounting records

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

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

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of Directors' remuneration have not been made or the part of the Directors' remuneration report to be audited is not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Other matters

Audit tenure

Following the recommendation of the audit committee, we were appointed by the Board of Directors of the Royal Bank of Scotland Group plc on 21 March 2000 to audit the financial statements for the year ending 31 December 2000 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 18 years, covering the years ending 31 December 2000 to 31 December 2017.

Consistency of the audit report with the additional report to the audit committee

Our audit opinion is consistent with the additional report to the audit committee we are required to provide in accordance with ISAs (UK).

Colin Rawlings FCA (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom
26 February 2018

Consolidated income statement
For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Gross earned premium	5	3,339.7	3,202.8
Reinsurance premium	5	(204.7)	(202.2)
Net earned premium	5	3,135.0	3,000.6
Investment return	6	175.4	171.5
Instalment income		116.4	107.1
Other operating income	7	62.9	58.2
Total income		3,489.7	3,337.4
Insurance claims	8	(1,571.1)	(2,179.0)
Insurance claims (payable to) / recoverable from reinsurers	8	(183.1)	375.2
Net insurance claims	8	(1,754.2)	(1,803.8)
Commission expenses	9	(286.4)	(344.0)
Operating expenses	10	(806.3)	(799.4)
Total expenses		(1,092.7)	(1,143.4)
Operating profit		642.8	390.2
Finance costs	11	(103.8)	(37.2)
Profit before tax		539.0	353.0
Tax charge	12	(105.0)	(74.2)
Profit for the year attributable to owners of the Company		434.0	278.8
Earnings per share:			
Basic (pence)	15	31.8	20.4
Diluted (pence)	15	31.5	20.2

The attached notes on pages 117 to 163 form an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income
For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Profit for the year		434.0	278.8
Other comprehensive (loss) / income			
Items that will not be reclassified subsequently to the income statement:			
Actuarial gain / (loss) on defined benefit pension scheme	25	2.1	(4.4)
Tax relating to item that will not be reclassified	13	(0.4)	0.7
		1.7	(3.7)
Items that may be reclassified subsequently to the income statement:			
Exchange differences on translation of foreign operations		–	0.1
Cash flow hedges		(1.1)	1.4
Fair value gain on AFS investments	30	8.8	119.6
Less: realised net gains on AFS investments included in income statement	30	(23.2)	(15.3)
Tax relating to items that may be reclassified	30	2.5	(17.6)
		(13.0)	88.2
Other comprehensive (loss) / income for the year net of tax		(11.3)	84.5
Total comprehensive income for the year attributable to owners of the Company		422.7	363.3

The attached notes on pages 117 to 163 form an integral part of these consolidated financial statements.

Consolidated balance sheet
As at 31 December 2017

	Notes	2017 £m	2016 £m
Assets			
Goodwill and other intangible assets	17	471.1	508.9
Property, plant and equipment	18	174.4	180.9
Investment property	19	309.3	329.0
Reinsurance assets	21	1,178.5	1,371.8
Current tax assets	13	0.1	0.1
Deferred acquisition costs	22	185.4	203.1
Insurance and other receivables	23	981.2	988.3
Prepayments, accrued income and other assets		146.2	131.0
Derivative financial instruments	24	84.4	79.7
Retirement benefit asset	25	14.4	12.0
Financial investments	26	5,040.4	5,147.0
Cash and cash equivalents	27	1,358.6	1,166.1
Assets held for sale	28	4.2	3.8
Total assets		9,948.2	10,121.7
Equity			
Shareholders' equity		2,715.1	2,521.5
Tier 1 notes	31	346.5	–
Total equity		3,061.6	2,521.5
Liabilities			
Subordinated liabilities	32	264.7	539.6
Insurance liabilities	33	4,225.7	4,666.6
Unearned premium reserve	34	1,600.3	1,547.9
Borrowings	27	54.1	55.3
Derivative financial instruments	24	12.0	45.1
Trade and other payables, including insurance payables	36	658.0	699.2
Deferred tax liabilities	13	31.1	46.0
Current tax liabilities	13	40.7	0.5
Total liabilities		6,886.6	7,600.2
Total equity and liabilities		9,948.2	10,121.7

The attached notes on pages 117 to 163 form an integral part of these consolidated financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 26 February 2018. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Consolidated statement of changes in equity

For the year ended 31 December 2017

	Share capital (note 29) £m	Employee trust shares £m	Capital reserves (note 30) £m	AFS revaluation reserve (note 30) £m	Non-distributable reserve £m	Foreign exchange translation reserve £m	Retained earnings £m	Shareholders' equity £m	Tier 1 notes £m	Total equity £m
Balance at 1 January 2016	150.0	(20.4)	1,450.0	5.4	152.9	(0.1)	892.2	2,630.0	–	2,630.0
Profit for the year	–	–	–	–	–	–	278.8	278.8	–	278.8
Other comprehensive income	–	–	–	86.7	–	1.5	(3.7)	84.5	–	84.5
Dividends paid (note 14)	–	–	–	–	–	–	(450.6)	(450.6)	–	(450.6)
Transfer from non-distributable reserve	–	–	–	–	(152.9)	–	152.9	–	–	–
Shares acquired by employee trusts	–	(39.5)	–	–	–	–	–	(39.5)	–	(39.5)
Credit to equity for equity-settled share-based payments (note 35)	–	–	–	–	–	–	16.8	16.8	–	16.8
Shares distributed by employee trusts	–	25.6	–	–	–	–	(25.6)	–	–	–
Tax on share-based payments	–	–	–	–	–	–	1.5	1.5	–	1.5
Balance at 31 December 2016	150.0	(34.3)	1,450.0	92.1	–	1.4	862.3	2,521.5	–	2,521.5
Profit for the year	–	–	–	–	–	–	434.0	434.0	–	434.0
Other comprehensive loss	–	–	–	(11.9)	–	(1.1)	1.7	(11.3)	–	(11.3)
Dividends paid (note 14)	–	–	–	–	–	–	(225.3)	(225.3)	–	(225.3)
Shares acquired by employee trusts	–	(19.6)	–	–	–	–	–	(19.6)	–	(19.6)
Credit to equity for equity-settled share-based payments (note 35)	–	–	–	–	–	–	14.8	14.8	–	14.8
Shares distributed by employee trusts	–	19.8	–	–	–	–	(19.8)	–	–	–
Tax on share-based payments	–	–	–	–	–	–	1.0	1.0	–	1.0
Issue of Tier 1 notes (note 31)	–	–	–	–	–	–	–	–	346.5	346.5
Balance at 31 December 2017	150.0	(34.1)	1,450.0	80.2	–	0.3	1,068.7	2,715.1	346.5	3,061.6

The attached notes on pages 117 to 163 form an integral part of these consolidated financial statements.

Consolidated cash flow statement

For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Net cash generated from operating activities before investment of insurance assets	37	204.0	35.0
Cash generated from investment of insurance assets	37	341.9	827.4
Net cash generated from operating activities		545.9	862.4
Cash flows from investing activities			
Purchases of property, plant and equipment	18	(22.4)	(49.9)
Purchases of goodwill and other intangible assets	17	(73.2)	(80.8)
Proceeds on disposals of assets held for sale		–	5.1
Proceeds on disposal of property, plant and equipment		0.3	–
Net cash used in investing activities		(95.3)	(125.6)
Cash flows from financing activities			
Net proceeds from issue of Tier 1 notes	31	346.5	–
Repayment of subordinated liabilities		(326.8)	–
Dividends paid	14	(225.3)	(450.6)
Finance costs		(31.7)	(38.3)
Purchase of employee trust shares		(19.6)	(39.5)
Net cash used in financing activities		(256.9)	(528.4)
Net increase in cash and cash equivalents		193.7	208.4
Cash and cash equivalents at the beginning of the year	27	1,110.8	902.4
Cash and cash equivalents at the end of the year	27	1,304.5	1,110.8

The attached notes on pages 117 to 163 form an integral part of these consolidated financial statements.

Corporate information

Direct Line Insurance Group plc is a public limited company registered in England and Wales (company number 02280426). The address of the registered office is Churchill Court, Westmoreland Road, Bromley, BR1 1DP, England.

1. Accounting policies

Basis of preparation

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

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

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

Adoption of new and revised standards

The Group has adopted the following new amendments to IFRSs and the IASs that became mandatorily effective for the Group for the first time during 2017 however these have no impact on the consolidated financial statements or performance.

Amendments to IAS 7 'Statement of Cash Flows' require an entity to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. On initial application of the amendment, entities are not required to provide comparative information.

The IASB amended IAS 12 'Income Taxes' – Recognition of Deferred Tax Assets for Unrealised Losses to clarify how to account for deferred tax assets related to debt instruments measured at fair value, particularly where changes in the market interest rate decrease the fair value of a debt instrument below cost. The amendments clarify that an entity needs to consider whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference. Furthermore, the amendments provide guidance on how an entity should determine future taxable profits and explain the circumstances in which taxable profit may include the recovery of some assets for more than their carrying amount.

IFRS 12 'Disclosure of Interests in Other Entities' – the amendment clarifies that the disclosure requirements of IFRS 12 are applicable to entities classified as held for sale or distribution.

1.1 Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and the entities that are controlled by the Group at 31 December 2017 and 31 December 2016. Control exists when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. In assessing if the Group controls another entity, the existence and effect of the potential voting rights that are currently exercisable or convertible are considered.

Where necessary, adjustments have been made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. The policies set out below have been applied consistently throughout the years ended 31 December 2017 and 31 December 2016 to items considered material to the consolidated financial statements.

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

All intercompany transactions, balances, income and expenses between Group entities are eliminated on consolidation.

1.2 Foreign currencies

The Group's consolidated financial statements are presented in sterling which is the presentational currency of the Group. Group entities record transactions in the currency of the primary economic environment in which they operate (their functional currency), translated at the foreign exchange rate ruling at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in the income statement.

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

Assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into 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 consolidated statement of comprehensive income. The amount accumulated in equity is reclassified from equity to the consolidated income statement on disposal or partial disposal of a foreign operation.

1. 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 policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

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

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

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

Cash back payments to policyholders under motor telematics policies represent a reduction in earned premiums.

Investment return
Interest income on financial assets is determined using the effective interest rate method. The effective interest rate method is a way of calculating the amortised cost of a financial asset (or group of financial assets) and of allocating the interest income over the expected life of the asset.

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

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

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

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

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

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

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

Legal services revenue represents the amount charged to clients for professional services provided during the year including recovery of expenses but excluding value added tax. Revenue is only recognised once services have been provided and certainty exists as to the outcome of the respective cases.

1.5 Insurance claims
Insurance claims are recognised in the accounting period in which the loss occurs. Provision is made for the full cost of settling outstanding claims at the balance sheet date, including claims incurred but not yet reported at that date, net of salvage and subrogation recoveries. Outstanding claims provisions are not discounted for the time value of money except for claims to be settled by PPOs established under the Courts Act 2003. A court can award damages for future pecuniary loss in respect of personal injury or for other damages in respect of personal injury and may order that the damages are wholly or partly to take the form of PPOs. These are covered in more detail in note 2.4. Costs for both direct and indirect claims handling expenses are also included.

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. When calculating the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims (gross and net) at the balance sheet date. Also included in the estimation of outstanding claims are factors such as the potential for judicial or legislative inflation.

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

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

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

1.6 Reinsurance

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

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

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

A reinsurance bad debt provision is assessed in respect of reinsurance debtors, to allow for the risk that the reinsurance asset may not be collected or where the reinsurer's credit rating has been downgraded significantly and this is taken as an indication of a reinsurer's difficulty in meeting its obligations under the reinsurance contracts. This also includes an assessment in respect of the ceded part of claims provisions to reflect the counterparty default risk exposure to long-term reinsurance assets particularly in relation to PPOs. Increases in this provision affect the Group by reducing the carrying value of the asset and the impairment loss is recognised in the income statement.

1.7 Deferred acquisition costs

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

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

1.8 Goodwill and other intangible assets

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

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

Software development costs	Up to 10 years

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

1.9 Property, plant and equipment

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

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

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

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

1. Accounting policies continued

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

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

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

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

1.11 Investment property

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

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

1.12 Financial assets

Financial assets are classified as AFS, held-to-maturity ("**HTM**"), designated at fair value through profit or loss, or loans and receivables.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the market place are recognised on the date that the Group commits to purchase or sell the asset.

AFS

Financial assets can be designated as AFS on initial recognition. AFS financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Impairment losses and exchange differences resulting from translating the amortised cost of foreign currency monetary AFS financial assets are recognised in the income statement, together with interest calculated using the effective interest rate method. Other changes in the fair value of AFS financial assets are reported in a separate component of shareholders' equity until disposal, when the cumulative gain or loss is recognised in the income statement.

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

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

HTM

Non-derivative financial assets not designated as AFS or loans and receivables with fixed or determinable payments and fixed maturity where the intention and ability to hold them to maturity exists are classified as HTM.

Subsequent to initial recognition, HTM financial assets are measured at amortised cost using the effective interest rate method less any impairment losses.

Loans and receivables

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

Impairment of financial assets

Insurance receivables

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

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

HTM and loans and receivables
If there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as HTM or 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.

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

Receivables also include amounts due in respect of the provision of legal services.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. Accounting policies continued

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

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

1.17 Leases

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

1.18 Pensions and other post-retirement benefits

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

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

The Group's defined benefit pension scheme, as described in note 25, was closed in 2003. Scheme liabilities are measured on an actuarial basis, using the projected unit credit method, and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities.

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

1.19 Taxation

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

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

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

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

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

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

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

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current assets and liabilities on a net basis.

1.20 Share-based payments

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

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

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

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

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

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

1.21 Capital instruments

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

The Tier 1 notes are classified as equity as they have a perpetual maturity and the Group has full discretion over interest payments, including ability to defer or cancel interest payments indefinitely.

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

1.22 Dividends

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

1.23 Accounting developments

New IFRSs and amendments that are issued, but not yet effective for the 31 December 2017 reporting period and have not been early adopted by the Group are disclosed below. The Group intends to adopt these standards, if applicable, when they become effective, except for IFRS 9 as explained below.

In July 2014, the IASB issued the final version of IFRS 9 'Financial Instruments' that replaces IAS 39 'Financial Instruments: Recognition and Measurement' and all previous versions of IFRS 9; it was endorsed by the EU in 2016. IFRS 9 addresses the classification, measurement and derecognition of financial assets and financial liabilities, introduces new rules for hedge accounting and a new impairment model for financial assets; it is effective for annual periods beginning on or after 1 January 2018.

In September 2016, the IASB issued amendments to IFRS 4 to address issues arising from the different effective dates of IFRS 9 and IFRS 17. The amendments to IFRS 4 were endorsed by the EU in November 2017.

In 2017 the Group conducted a high-level assessment of the three aspects of IFRS 9 and based on current information, the impact of applying the expected loss model for the first time is currently immaterial. The Group does not expect any other significant impact on its financial statements. The Group satisfies the exemption criteria within IFRS 4 'Insurance Contracts' and has decided to defer the application of IFRS 9 until the effective date of the new insurance contracts standard IFRS 17 of 1 January 2021, applying the temporary exemption from applying IFRS 9 as introduced by the amendments to IFRS 4.

In May 2014 the IASB issued IFRS 15 'Revenue from Contracts with Customers' to establish a single comprehensive model to use in accounting for revenue recognition and measurement. The standard provides guidance on when and how combined contracts should be unbundled and when a contract price includes a variable consideration element.

IFRS 15 was endorsed by the EU in 2016 and either a full retrospective application or a modified retrospective application is required for annual periods beginning on or after 1 January 2018. During 2017 the Group reviewed all non-insurance revenue and expects to apply IFRS 15 fully retrospectively. Insurance contracts are out of the scope of IFRS 15 and therefore the Group does not expect the impact on other operating income to be material.

In January 2016 the IASB issued IFRS 16 'Leases' to replace the existing leasing standard IAS 17; it was endorsed by the EU in October 2017 and will be effective from 1 January 2019. IFRS 16 sets out the principles for recognition, measurement, presentation and disclosure of leases and requires lessees to account for all leases under a single on-balance sheet model similar to the accounting for finance leases under IAS 17. There are two exemptions: for leases of a low value and for leases of a short-term nature of 12 months or less. At the start of a lease a lessee will recognise a liability for the lease payments and an asset, representing the right to use the asset during the lease term. Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. Lessor accounting under IFRS 16 is substantially unchanged from the current approach under IAS 17.

In 2018, the Group will continue to assess the potential effect of IFRS 16 on its consolidated financial statements; the undiscounted value of the Group's lease obligations is disclosed in note 39. The Group does not expect the impact on operating expenses or finance costs to be material.

In December 2016 the IASB issued 'Annual Improvements to IFRS Standards 2014-2016 Cycle' that included the two following improvements:

IFRS 1 'First-time Adoption of International Financial Reporting Standards' – the amendment deletes certain short-term exemptions for first-time adopters (IASB effective date of 1 January 2018);

IAS 28 'Investments in Associations and Joint Ventures' – the amendment provides clarification that measuring investees at fair value through profit or loss is an investment-by-investment choice; it is effective from 1 January 2018.

The following new standard and amendments to IFRSs and IASs have been issued and are expected to be endorsed by the EU during 2018. With the exception of the new standard IFRS 17 'Insurance Contracts', the Group does not expect the following amendments to have a material impact on the financial statements of the Group in future periods.

1. Accounting policies continued

IFRS 17 'Insurance Contracts' was issued by the IASB in May 2017 to replace IFRS 4 'Insurance Contracts', and will be effective for reporting periods beginning on or after 1 January 2021, with comparative figures required. IFRS 17 is a comprehensive new accounting standard for all insurance contracts covering recognition and measurement, presentation and disclosure. The overall objective of IFRS 17 is to provide an accounting model for insurance contracts that is more useful and consistent for insurers and to replace the requirements of IFRS 4 that allowed insurers to apply grandfathering of previous local accounting policies. IFRS 17 provides a comprehensive model for insurance contracts, covering all relevant accounting aspects.

The core of IFRS 17 is the general model, supplemented by an optional simplified premium allocation approach which is permitted for the liability for the remaining coverage for short-duration contracts. The general model measures insurance contracts using the building blocks of: discounted probability-weighted cash flows; an explicit risk adjustment; and a contractual service margin representing the unearned profit of the contract which is recognised as revenue over the coverage period.

An assessment will be undertaken during 2018 of the impact of IFRS 17 on the Group's financial statements. The Group expects to be able to apply the simplified premium allocation approach to most of its insurance and reinsurance contracts.

The IASB amended IFRS 2 'Share-based Payments' – Classification and Measurement of Share-based Payment Transactions, to address three main areas: the effects of vesting conditions on the measurement of a cash-settled share-based payment transaction; the classification of a share-based payment transaction with net settlement features for withholding tax obligations; and accounting where a modification to the terms and conditions of a share-based payment transaction changes its classification from cash-settled to equity-settled; the amendments are effective from 1 January 2018.

The IASB issued amendments to IAS 40 'Investment Property' – Transfers of Investment Property in December 2016 to clarify when an entity should transfer property, including property under construction or development into, or out of investment property. The amendments state that a change in use occurs when the property meets, or ceases to meet, the definition of an investment property and there is evidence of the change in use. The amendments are effective from 1 January 2018.

Amendments to IAS 28 'Investments in Associates and Joint Ventures'– Long-term Interests in Associates and Joint Ventures were issued in October 2017 to clarify that an entity applies IFRS 9 to long-term interests in associates or joint ventures that form part of the net investment in the associate or joint venture but to which the equity method is not applied. The amendments are effective from 1 January 2019.

Amendments to IFRS 9 'Financial Instruments' – Prepayment Features with Negative Compensation was issued in October 2017 to allow instruments with symmetric prepayment options to qualify for amortised cost or fair value through other comprehensive income measurement because they would otherwise fail the 'solely payments of principal and interest on the principal amount' condition. The amendments are effective from 1 January 2019.

In December 2017 the IASB issued 'Annual Improvements to IFRS Standards 2015-2017 Cycle' with an effective date of 1 January 2019, which included the following three amendments:

IFRS 3 'Business Combinations' and IFRS 11 'Joint Arrangements' – the amendments to IFRS 3 clarify that when an entity obtains control of a business that is a joint operation, it remeasures previously held interests in that business; the amendments to IFRS 11 clarify that when an entity obtains joint control of a business that is a joint operation, the entity does not remeasure previously held interests in that business.

IAS 12 'Income Taxes' – the amendments clarify that all income tax consequences of dividends should be recognised in profit or loss, regardless of how the tax arises.

IAS 23 'Borrowing Costs'– the amendments clarify that if any specific borrowing remains outstanding after the related asset is ready for its intended use or sale, that borrowing becomes part of the funds that an entity borrows generally when calculating the capitalisation rate on general borrowings.

IFRIC 22 'Foreign Currency Transactions and Advance Consideration' was issued in December 2016 and the interpretation clarifies how to determine the date of transaction for the exchange rate to be used on initial recognition of a related asset, expense or income (or part of it) where an entity pays or receives consideration in advance for foreign currency-denominated contracts and has an effective date of 1 January 2018.

IFRIC 23 'Uncertainty over Income Tax Treatments' was issued in June 2017 and provides interpretation when there is uncertainty over income tax treatments under IAS 12 'Income Taxes' and has an effective date of 1 January 2019.

2. Critical accounting judgements and key sources of estimation uncertainty

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 117 to 124. Company law and IFRSs require the Directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent.

In the absence of an applicable standard or interpretation, IAS 8 '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 Impairment provisions – financial assets

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

On a quarterly basis, the Group reviews whether there is any objective evidence that a financial asset is impaired based on the following criteria:

- actual, or imminent, default on coupon interest or nominal;
- adverse movements in the credit rating for the investee / borrower; or
- price performance of a particular AFS debt security, or group of AFS debt securities, demonstrating an adverse trend compared to the market as a whole.

There was £9.5 million impairment within loans and receivables of the Group's financial assets in the year ended 31 December 2017 (2016: £nil).

Had all the declines in AFS asset values met the criteria above at 31 December 2017, the Group would suffer a loss of £6.5 million (2016: £12.6 million), being the transfer of the total AFS reserve for unrealised losses to the income statement. These movements represent mark-to-market movements and where there is no objective evidence of any loss events that could affect future cash flows, no impairments are recorded for these movements.

2.2 Fair value

The Group has made the judgement that level 1 of the Group's fair value hierarchy set out in note 40 will include only sovereign debt securities issued by members of the G10 group of countries within the Group's AFS debt securities portfolio, with all other financial assets and liabilities carried at fair value included in level 2 as they are not considered to be quoted in a deeply liquid market.

The Group has also made the judgement that investment properties, most of the HTM debt securities, commercial real estate loans and infrastructure debt fall within level 3 of the Group's fair value hierarchy (note 40) as the valuation models used are driven predominantly by unobservable inputs: investment property valuations are derived from recent market transactions which are adjusted for specific characteristics of each property including the size, location and condition by reference to the benchmark property transactions.

2.3 Goodwill and other intangible assets

Goodwill impairment testing inherently involves estimation uncertainty in a number of areas including: the preparation of the five-year strategic plan and the extrapolation of cash flow forecasts beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the CGUs; estimation of market values of CGUs; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details of a sensitivity analysis on the recoverable amount in excess of carrying value are shown in note 17.

Impairment testing of software development costs involves estimation uncertainty in a number of areas including: the projection of the economic benefits associated with each asset; subsequent re-measurement of these benefits through the development cycle and into use; and the projected ultimate cost of each asset at each point through the development cycle due to specification changes.

2.4 General insurance: outstanding claims provisions and related reinsurance recoveries

The Group makes provision for the full cost of outstanding claims from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and claims handling. Outstanding claims provisions net of related reinsurance recoveries at 31 December 2017 amounted to £3,144.5 million (2016: £3,388.3 million).

2. Critical accounting judgements and key sources of estimation uncertainty continued

2.4 General insurance: outstanding claims provisions and related reinsurance recoveries continued

Claims reserves are assessed separately for large and attritional claims, typically using standard actuarial methods of projection. Key sources of estimation uncertainty include those arising from the selection of specific methods as well as assumptions for claims frequency and severity through the review of historical claims and emerging trends.

The corresponding reinsurance recoveries and impairment provision are calculated on an equivalent basis, with similar estimation uncertainty, as discussed in note 1.6. The reinsurance bad debt provision is mainly for expected recoveries against future PPO payments.

The most common method of settling bodily injury claims is by a lump sum paid to the claimant and, in the cases where this includes an element of indemnity for recurring costs such as loss of earnings or ongoing medical care, settlement calculations have reference to a standardised Ogden annuity factor at a discount rate of minus 0.75% in 2017 (2016: minus 0.75%). This is normally referred to as the Ogden discount rate. Other estimates are also required for case management expenses, loss of pension, court protection fees, alterations to accommodation and transportation fees.

The Lord Chancellor changed the Ogden discount rate from 2.5% to minus 0.75% in March 2017 based on a 3-year average of yields on index-linked government securities which will be sensitive to future movements in these instruments. The Government is currently planning to review the Ogden discount rate again based on 'low risk' investments rather than 'very low risk' investments, however, there is considerable uncertainty if, when and how a change might be made.

The Group will continue to exercise judgement around the Ogden rate used in its reserves allowing for the possibility for it to change in the future. It considers the uncertainties around the legal framework and its implementation as being significant and therefore provisions at the current proposed rate of minus 0.75%. An allowance for further movements in the Ogden rate is made within the Group's Solvency II balance sheet and capital requirements. Details of the IFRS sensitivity analysis to the assumed Ogden discount rate are shown in note 3.3.1. However, it should be noted that the Government is considering not only the appropriate level for the rate but also the methodology of how it is applied, so any sensitivity has considerable limitations.

The Group settles some large bodily injury claims as PPOs rather than lump sum payments.

The table below analyses the outstanding PPO claims provisions on a discounted and an undiscounted basis at 31 December 2017 and 31 December 2016. These represent the total cost of PPOs rather than any costs in excess of purely Ogden-based settlement.

At 31 December	Discounted 2017 £m	Undiscounted 2017 £m	Discounted 2016 £m	Undiscounted 2016 £m
Gross claims				
Approved PPO claims provisions	524.9	1,460.3	489.0	1,388.0
Anticipated PPOs	373.8	974.7	494.0	1,509.9
Total	898.7	2,435.0	983.0	2,897.9
Reinsurance				
Approved PPO claims provisions	(276.5)	(806.8)	(248.6)	(754.4)
Anticipated PPOs	(240.4)	(680.7)	(263.1)	(875.4)
Total	(516.9)	(1,487.5)	(511.7)	(1,629.8)
Net of reinsurance				
Approved PPO claims provisions	248.4	653.5	240.4	633.6
Anticipated PPOs	133.4	294.0	230.9	634.5
Total	381.8	947.5	471.3	1,268.1

The provisions for PPOs have been categorised as either claims which have already been determined by the courts as PPOs (approved PPO claims provisions) or those expected to settle as PPOs in the future (anticipated PPOs). The Group is subject to estimation uncertainty on the propensity of large bodily injury claims to move from Ogden settled values to PPOs. The estimates in the table above are based on historically observed propensity and the recent change in the Ogden discount rate. They do not allow for any future changes in PPO propensity. Anticipated PPOs consist of both existing large loss case reserves including allowances for development and claims yet to be reported to the Group. Reinsurance is applied at claim level and the net cash flows are discounted for the time value of money. The discount rate is consistent with the long duration of the claims payments and the assumed future indexation of the claims payments.

In the majority of cases, the inflation agreed in the settlement is the Annual Survey of Hours and Earnings SOC 6115 inflation published by the Office for National Statistics, for which the long-term rate is assumed to be 4.0% (2016: 4.0%). The rate of interest used for the calculation of present values is 4.0% (2016: 4.0%), which results in a real discount rate of 0.0% (2016: 0.0%).

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

3. Risk management

3.1 Enterprise risk management strategy and framework

The ERMF sets out, at a high level, our approach and processes for managing risks. Further information can be found in the risk management section of the strategic report on page 23.

3.2 Risk and capital management modelling

The Board has ultimate responsibility for ensuring that the Group has sufficient funds to meet its liabilities as they fall due. The Group carries out detailed modelling of its assets, liabilities and the key risks to which these are exposed. This modelling includes the Group's own assessment of its SCR. In 2015, this SCR assessment was submitted to the PRA as part of the Group's Internal Model Approval Process for which approval was subsequently granted in June 2016. The SCR quantifies the insurance, market, credit and operational risks that the regulated entities are undertaking.

The Board is closely involved in the SCR process and reviews, challenges and approves its assumptions and results.

3.3 Principal risks from insurance activities and use of financial instruments

The risk management section of the strategic report sets out all the risks assessed by the Group as principal risks. Detailed below is the Group's risk exposure arising from its insurance activities and use of financial instruments specifically in respect of insurance risk, market risk, operational risk and credit risk.

3.3.1 Insurance risk

The Group is exposed to insurance risk as a primary consequence of its business. Key insurance risks focus on the risk of loss due to fluctuations in the timings, amount, frequency and severity of an insured event relative to the expectations at the time of underwriting.

The Group is mainly exposed to the following insurance risks:

Reserve risk

Reserve risk relates to both premium and claims. This is the risk of understatement of reserves arising from:

- the uncertain nature of claims;
- data issues and changes to the claims reporting process;
- operational failures;
- failure to recognise claims trends in the market; and
- changes in underwriting and business written so that past trends are not necessarily a predictor of the future.

Understatement of reserves may result in not being able to pay claims when they fall due. Alternatively, overstatement of reserves can lead to a surplus of funds being retained resulting in opportunity cost; for example lost investment return or insufficient resource to pursue strategic projects and develop the business.

Reserve risk is controlled through a range of processes:

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

The Group's reserves are subject to the risk of retrospective changes in judicial conditions such as the change in the Ogden discount rate announced on 27 February 2017. This is the discount rate set by the Lord Chancellor and used by courts to calculate lump sum awards in bodily injury cases. The rate had been 2.5% since 2001 but was changed to minus 0.75% from 20 March 2017. The Group subsequently revised its reserve estimation to be based on the new rate, although this rate may change again in future, depending on the outcome of the Government's consultation on the framework for setting the rate and on the frequency and timing of future changes.

Uncertainty in claims reserves estimation is larger for claims such as PPOs for which annually indexed payments are made, typically over the lifetime of the injured party. Claims reserves for PPOs are held on a discounted basis and are sensitive to a change in the assumed real discount rate.

3. Risk management continued

The tables below provide a sensitivity analysis of the potential impact of a change in a single factor (discount rate used for PPOs, Ogden discount rate) with all other assumptions left unchanged. Other potential risks beyond the ones described could have an additional financial impact on the Group.

At 31 December	Increase / (decrease) in profit before tax and equity[3,4] 2017 £m	2016 £m
PPOs[1]		
Impact of an increase in the discount rate used in the calculation of present values of 100 basis points	54.6	68.2
Impact of a decrease in the discount rate used in the calculation of present values of 100 basis points	(75.1)	(97.9)
Ogden discount rate[2]		
Impact of the Group reserving at a discount rate of 0% compared to minus 0.75%	68.4	102.1
Impact of the Group reserving at a discount rate of minus 1.5% compared to minus 0.75%	(102.9)	(156.4)

Notes:

1. The sensitivities relating to an increase or decrease in the real discount rate used for PPOs illustrate a movement in the time value of money from the assumed level of 0.0%. The PPO sensitivity has been calculated on the direct impact on the change in the real discount rate with all other factors remaining unchanged.
2. Ogden discount rate sensitivity has been calculated on the direct impact of a permanent change in the discount rate with all other factors remaining unchanged. The Group will consider the statutory discount rate when setting its reserves but not necessarily provide on this basis. This is to ensure that reserves are appropriate for current and potential future developments.
3. These sensitivities exclude the impact of taxation.
4. These sensitivities reflect one-off impacts at 31 December and should not be interpreted as predictions.

The sensitivity above is calculated on the basis of a permanent change in the rate on the actuarial best estimate reserves as at 31 December 2017. It does not take into account a change in the Ogden discount rate setting regime, nor any second order impacts such as those on the Group's PPO assumptions or reinsurance bad debt assumptions. The year on year reduction in sensitivity to a change in the Ogden discount rate reflects a £49 million reserve release arising after a detailed case review of the Group's 2016 Ogden provision as well as the overall reduction in bodily injury exposures. This is due to continued positive prior-year development of claims reserves for large bodily injury claims, particularly for accident years where the reinsurance retention level was higher than the current level of £1 million.

There is the risk that claims are reserved or paid inappropriately, including the timing of such activity. However, there are claims management controls in place to mitigate this risk, as outlined below:

- claims are managed utilising a range of IT system-driven controls coupled with manual processes outlined in detailed policies and procedures to ensure claims are handled in an appropriate, timely and accurate manner;
- each member of staff has a specified handling authority, with controls preventing them handling or paying claims outside their authority, as well as controls to mitigate the risk of paying invalid claims. In addition, there are various outsourced claims handling arrangements, all of which are monitored closely by management, with similar principles applying in terms of the controls and procedures;
- loss adjustors are used in certain circumstances to handle claims to conclusion. This involves liaison with the policyholder, third parties, suppliers and the claims function;
- specialist bodily injury claims teams are responsible for handling these types of losses with the nature of handling dependent on the level and type of claim. Claims exceeding a certain threshold are referred to the technical and large loss teams who also deal with all other claim types above defined limits or within specific criteria; and
- a process is in place to deal with major weather and other catastrophic events, known as the 'Surge Demand Plan'. A surge is the collective name given to an incident which significantly increases the volume of claims reported to the Group's claims functions. The plan covers surge demand triggers, stages of incident, operational impact, communication and management information monitoring of the plan.

Underwriting risk

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

Underwriting risk includes catastrophe risk and the risk of loss, or of adverse change in the value of the insurance liabilities resulting from significant uncertainty of pricing, underwriting and provisioning assumptions related to extreme or exceptional circumstances.

When underwriting policies, the Group is subject to concentration risk in a variety of forms, including:

- geographic concentration risk – the Group purchases a catastrophe reinsurance programme to protect against a modelled one in 200-years catastrophe loss. The retained deductible is 13.99% of the gross earned premium of the preceding 12 months and at 31 December 2017 was £147 million (2016: £150 million)
- product concentration risk – the Group's business is heavily concentrated in the UK general insurance market. However, the Group offers a diversified portfolio of products and a variety of brands sold through a range of distribution channels to its customers; and
- sector concentration risk – the concentration of the Group to any given industry sector is monitored and analysed in respect of commercial customers

It is important to note that none of these risk categories is independent of the others and that giving due consideration to the relationship between these risks is an important aspect of the effective management of insurance risk.

Distribution risk
This is the risk that material change in the volume of policies written may result in losses or reduced profitability.

Pricing risk
This is the risk of economic loss arising from policies being incorrectly priced or accepted to achieve desired volume and profitability.

Reinsurance risk
This is the risk of inappropriate selection and / or placement of reinsurance arrangements, with either individual or multiple reinsurers which renders the transfer of insurance risk to the reinsurer(s) inappropriate and / or ineffective. Other risks include:

- reinsurance concentration risk – the concentration of credit exposure to any given counterparty;
- reinsurance capacity being reduced and / or withdrawn;
- underwriting risk appetite and reinsurance contract terms not being aligned;
- reinsurance contract terms being inappropriate or ineffective resulting in classes or types of business not being appropriately reinsured;
- non-adherence to the reinsurance policy terms and conditions, in terms of both policy management and claims not being handled within the reinsurance contract terms and conditions or paid on an ex-gratia basis resulting in reinsurance recoveries not being made in full;
- inappropriate or inaccurate management information and / or modelling being used to determine the value for money and purchasing of reinsurance (including aggregate modelling); and
- changes in the external legal, regulatory, social or economic environment altering the definition and application of reinsurance policy wordings or the effectiveness or value for money of reinsurance.

The Group uses reinsurance to:

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

3.3.2 Market risk
Market risk is the risk of loss resulting from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.

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

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

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

3. Risk management continued

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

The strategic asset allocation within the investment portfolio is reviewed by the Investment Committee, which makes recommendations to the Board for its investment strategy approval. The Investment Committee determines policy and controls, covering such areas as risk, liquidity and performance. The Investment Committee meets at least three times a year to evaluate risk exposure, the current strategy, associated policies and investment guidelines and to consider investment recommendations submitted to it. Oversight of the implementation of decisions taken by the Investment Committee is via the First and Second Lines of Defence.

The investment management objectives are to:

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

The Group has a property portfolio and an infrastructure debt portfolio to generate a real return which, from an asset liability matching perspective, is used to offset the liability arising from longer duration PPOs.

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

Spread risk
This is the risk of loss from the sensitivity of the value of assets and investments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure. The level of spread is the difference between the risk-free rate and actual rate paid on the asset, with larger spreads being associated with higher risk assets. The Group is exposed to spread risk through its investments in bonds.

Interest rate risk
This is the risk of loss from all assets and liabilities for which the net asset value is sensitive to changes in the term structure of interest rates or interest rate volatility. The Group's interest rate risk arises mainly from its debt, floating interest rate investments and assets and liabilities exposed to fixed interest rates.

The subordinated guaranteed dated notes with a nominal value of £500 million were issued on 27 April 2012 at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year designated hedging instrument to exchange the fixed rate of interest for a floating rate of three-month LIBOR plus a spread of 706 basis points which was credit value adjusted to 707 basis points with effect from 29 July 2013.

On 8 December 2017, the Group repurchased £250 million nominal value of the subordinated guaranteed dated notes for a purchase price of £330.1 million including accrued interest of £2.7 million and associated transaction costs of £0.6 million.

The remaining notes, with a nominal value of £250 million, have a redemption date of 27 April 2042 with the option to repay the notes on 27 April 2022. If the notes are not repaid on that date, the rate of interest will be reset at a rate of the six-month LIBOR plus 7.91%.

On 7 December 2017, the Group issued £350 million of fixed rate perpetual Tier 1 notes with a coupon rate of 4.75% per annum.

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

The market value of the Group's financial investments with fixed coupons is affected by the movement of interest rates. For the majority of investments in US Dollar corporate bonds, excluding £403.9 million of short duration high yield bonds (2016: £432.0 million) the Group hedges the exposure of this portfolio to the US Dollar interest rate risk using swaps.

Property risk
This is the risk of loss arising from sensitivity of assets and financial investments to the level or volatility of market prices, rental yields, or occupancy rates of properties. At 31 December 2017, the value of these property investments was £309.3 million (2016: £329.0 million). The property investments are located in the UK.

Currency risk
This is the risk of loss from changes in the level or volatility of currency exchange rates.

Exposure to currency risk is generated by the Group's investments in US Dollar and Euro denominated corporate bonds.

The Group maintains exposure to US Dollar securities through £2,084.5 million (2016: £2,107.1 million) of investments in US Dollar corporate bonds and Euro securities through £110.4 million (2016: £91.8 million) of Euro corporate bonds. The foreign currency exposure of these investments is hedged by foreign currency forward contracts, maintaining a minimal unhedged currency exposure on these portfolios, as well as a low basis risk on the hedging contracts.

A limited exposure to currency risk also arises through the Group's insurance and other contractual liabilities.

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

	Increase / (decrease) in profit before tax[5]		Decrease in total equity[5] at 31 December	
	2017 £m	2016 £m	**2017 £m**	2016 £m
Spread				
Impact of a 100 basis points increase in spreads on financial investments[1,2,4]	**–**	–	**(183.5)**	(183.1)
Interest rate				
Impact of a 100 basis points increase in interest rates on financial investments and derivatives[1,2,3,4]	**17.3**	21.5	**(98.3)**	(101.5)
Investment property				
Impact of a 15% decrease in property markets	**(46.4)**	(49.4)	**(46.4)**	(49.4)

Notes:

1. The income statement impact on financial investments is limited to floating rate instruments and interest rate derivatives used to hedge a portion of the portfolio. The income statement is not impacted in relation to fixed rate instruments, in particular AFS debt securities, where the coupon return is not impacted by a change in prevailing market rates, as the accounting treatment for AFS debt securities means that only the coupon received is processed through the income statement with fair value movements being recognised through total equity.
2. The increase or decrease in total equity does not reflect any fair value movement in infrastructure debt, HTM debt securities and commercial real estate loans that would not be recorded in the financial statements under IFRSs as they are classified as loans and receivables and HTM respectively, which are carried at amortised cost. It is estimated that a fair value reduction in these asset categories resulting from a 100 basis points increase in spreads would have been £23.7 million (2016: £34.4 million) and a 100 basis points increase in interest rate would have been £6.2 million (2016:£4.8 million).
3. The sensitivities set out above reflect one-off impacts at 31 December with the exception of the income statement interest rate sensitivity on financial investments and derivatives, which projects a movement in a full year's interest charge as a result of the increase in the interest rate applied to these assets or liabilities on those positions held at 31 December.
4. The subordinated liabilities and associated interest rate swap are excluded from the sensitivity analysis.
5. These sensitivities exclude the impact of taxation.
6. The sensitivities set out above have not considered the impact of the general market changes on the value of the Group's insurance liabilities or retirement benefit obligations. They reflect one-off impacts at 31 December and should not be interpreted as predictions.

The Group has a number of open interest rate and foreign exchange derivative positions. Collateral management arrangements are in place for significant counterparty exposures. At 31 December 2017, the Group has pledged £28.2 million in cash (2016: £23.7 million) and £0.3 million in UK Gilts (2016: £3.4 million) to cover initial margins and out-of-the-money derivative positions. At 31 December 2017, counterparties have pledged £25.1 million in cash and £15.5 million in UK Gilts (2016: £19.1 million in cash and £39.4 million in UK Gilts) to the Group to cover in-the-money derivative positions.

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

3.3.3 Credit risk

This is the risk of loss resulting from default in cash inflows and / or changes in market value of issuers of securities, counterparties and any debtors to which the Group is exposed. The Group is mainly exposed to the following credit risk factors:

- counterparty default risk; and
- concentration risk.

Counterparty default risk
This is the risk of loss from unexpected default of the counterparties and debtors of Group undertakings. This risk is monitored by three forums: the Investment risk forum monitors credit spreads as indicators of potential losses on investments incurred but not yet realised; the Credit risk forum monitors reinsurance and corporate insurance counterparty default risk; and the NIG credit committee is responsible for monitoring broker credit risk. The main responsibility of these forums is to ensure that all material aspects of counterparty default risk within the Group are identified, monitored and measured.

3. Risk management continued

The main sources of counterparty default risk for the Group are:

- investments – this arises from the investment of funds in a range of investment vehicles permitted by the investment policy
- reinsurance recoveries – counterparty exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed. PPOs have the potential to increase the ultimate value of a claim and, by their very nature, to increase significantly the length of time to reach final payment. This can increase reinsurance counterparty default risk in terms of both amount and longevity; and
- consumer credit – exposure from offering monthly instalments on annual insurance contracts

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

Certain reinsurance contracts have long durations as a result of bodily injury and PPO claims, and insurance reserves therefore include provisions beyond the levels created for shorter-term reinsurance bad debt. For these contracts, reinsurance is only purchased from reinsurers that hold a credit rating of at least A+ at the time cover is purchased.

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

At 31 December 2017	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
Reinsurance assets	1,178.5	–	–	–	1,178.5
Insurance and other receivables	942.5	38.2	0.5	–	981.2
Derivative assets	84.4	–	–	–	84.4
Debt securities	4,555.0	–	–	–	4,555.0
Infrastructure debt	316.4	–	–	–	316.4
Commercial real estate loans	169.0	–	–	–	169.0
Cash and cash equivalents[1]	1,358.6	–	–	–	1,358.6
Total	8,604.4	38.2	0.5	–	8,643.1

At 31 December 2016	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
Reinsurance assets	1,371.8	–	–	–	1,371.8
Insurance and other receivables	937.8	38.0	12.5	–	988.3
Derivative assets	79.7	–	–	–	79.7
Debt securities	4,730.3	–	–	–	4,730.3
Infrastructure debt	337.0	–	–	–	337.0
Commercial real estate loans	79.7	–	–	–	79.7
Cash and cash equivalents[1]	1,166.1	–	–	–	1,166.1
Total	8,702.4	38.0	12.5	–	8,752.9

Note:
1. This represents money market funds with no notice period for withdrawal and cash at bank and in hand.

Within the analysis of debt securities above are bank debt securities at 31 December 2017 of £1,197.4 million (2016: £1,199.5 million), that can be further analysed as: secured £63.5 million (2016: £62.2 million); unsecured £976.3 million (2016: £973.8 million); and subordinated £157.6 million (2016: £163.5 million).

Concentration risk
This is the risk of loss associated with inadequately diversified portfolios of assets and / or obligations, in particular:

- large exposures to individual credits (either bond issuers or deposit-taking institutions); and
- large exposures to different credits where movements in values and ratings are closely correlated.

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

The table below analyses the distribution of debt securities, by geographical area (commercial real estate loans and infrastructure debt are all within the UK).

At 31 December 2017	Corporate £m	Local government £m	Sovereign £m	Supranational £m	Debt securities total £m
Australia	101.7	–	–	–	101.7
Austria	1.8	–	–	–	1.8
Belgium	39.6	–	9.5	–	49.1
Bermuda	6.4	–	–	–	6.4
Canada	35.6	–	–	–	35.6
Cayman Islands	16.8	–	–	–	16.8
Denmark	18.2	–	–	–	18.2
France	216.3	3.6	–	–	219.9
Germany	231.9	–	–	–	231.9
Hong Kong	3.9	–	–	–	3.9
Ireland	9.9	–	–	–	9.9
Italy	23.1	–	–	–	23.1
Japan	53.0	–	–	–	53.0
Luxembourg	4.5	–	–	–	4.5
Mexico	10.6	–	–	–	10.6
Netherlands	166.6	–	–	–	166.6
New Zealand	18.1	–	–	–	18.1
Norway	27.1	–	–	–	27.1
Singapore	25.0	–	–	–	25.0
South Korea	3.8	–	–	–	3.8
Spain	42.1	–	–	–	42.1
Sweden	80.6	8.6	–	–	89.2
Switzerland	104.5	–	–	–	104.5
UK	1,113.2	–	215.3	–	1,328.5
USA	1,919.8	–	–	–	1,919.8
Supranational	–	–	–	43.9	43.9
Total	**4,274.1**	**12.2**	**224.8**	**43.9**	**4,555.0**

3. Risk management continued

The table below analyses the distribution of debt securities by geographical area (commercial real estate loans and infrastructure debt are all within the UK).

At 31 December 2016	Corporate £m	Local government £m	Sovereign £m	Supranational £m	Debt securities total £m
Australia	100.2	–	–	–	100.2
Belgium	59.7	–	9.7	–	69.4
Canada	33.3	–	–	–	33.3
Cayman Islands	17.5	–	–	–	17.5
Denmark	15.6	–	–	–	15.6
France	226.2	3.6	–	–	229.8
Germany	277.0	–	–	–	277.0
Hong Kong	11.8	–	–	–	11.8
Ireland	2.1	–	–	–	2.1
Italy	25.9	–	4.2	–	30.1
Japan	42.9	–	–	–	42.9
Luxembourg	6.2	–	–	–	6.2
Mexico	11.8	–	–	–	11.8
Netherlands	166.2	–	–	–	166.2
New Zealand	7.0	–	–	–	7.0
Norway	27.6	–	–	–	27.6
Portugal	1.1	–	–	–	1.1
Singapore	25.6	–	–	–	25.6
South Korea	8.4	9.4	–	–	17.8
Spain	38.0	–	–	–	38.0
Sweden	74.2	8.7	–	–	82.9
Switzerland	92.1	–	–	–	92.1
UK	1,093.3	–	324.9	–	1,418.2
USA	1,905.1	–	2.4	–	1,907.5
Supranational	–	–	–	98.6	98.6
Total	4,268.8	21.7	341.2	98.6	4,730.3

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

At 31 December	2017		2016	
	£m	%	£m	%
Basic materials	110.3	3%	132.6	3%
Communications	239.2	5%	234.1	5%
Consumer, cyclical	374.9	8%	349.1	7%
Consumer, non-cyclical	494.4	11%	520.7	11%
Diversified	57.9	1%	57.3	1%
Energy	263.6	6%	310.8	7%
Financial	1,836.1	40%	1,776.9	38%
Industrial	216.2	5%	215.3	4%
Sovereign, supranational and local government	280.9	6%	461.5	10%
Technology	163.1	4%	137.6	3%
Transport	13.4	0%	10.1	0%
Utilities	505.0	11%	524.3	11%
Total	4,555.0	100%	4,730.3	100%

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

At 31 December	2017 £m	2017 %	2016 £m	2016 %
Social, of which:				
Education	**140.5**	**44%**	145.5	43%
Healthcare	**84.3**	**27%**	96.0	29%
Other	**56.3**	**18%**	57.6	17%
Transport	**35.3**	**11%**	37.9	11%
Total	**316.4**	**100%**	337.0	100%

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

At 31 December 2017	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB– £m	BB+ and below £m	Total £m
Corporate	183.1	412.0	2,145.8	1,144.6	388.6	**4,274.1**
Supranational	39.3	4.6	–	–	–	**43.9**
Local government	–	12.2	–	–	–	**12.2**
Sovereign	–	224.8	–	–	–	**224.8**
Total	**222.4**	**653.6**	**2,145.8**	**1,144.6**	**388.6**	**4,555.0**

At 31 December 2016	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB– £m	BB+ and below £m	Total £m
Corporate	192.3	524.1	2,135.9	1,006.6	409.9	4,268.8
Supranational	94.0	4.6	–	–	–	98.6
Local government	–	21.7	–	–	–	21.7
Sovereign	2.4	334.6	–	4.2	–	341.2
Total	288.7	885.0	2,135.9	1,010.8	409.9	4,730.3

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

At 31 December 2017	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB– £m	BB+ and below £m	Not rated £m	Total £m
Reinsurance assets	–	823.2	349.5	1.0	–	4.8	**1,178.5**
Insurance and other receivables[1]	–	24.7	15.1	10.0	–	892.7	**942.5**
Derivative assets	–	34.5	33.4	16.5	–	–	**84.4**
Infrastructure debt	–	–	81.2	229.2	6.0	–	**316.4**
Commercial real estate loans	13.8	34.8	101.1	19.3	–	–	**169.0**
Cash and cash equivalents[2]	1,100.6	134.6	46.8	76.6	–	–	**1,358.6**
Total	**1,114.4**	**1,051.8**	**627.1**	**352.6**	**6.0**	**897.5**	**4,049.4**

At 31 December 2016	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB– £m	BB+ and below £m	Not rated £m	Total £m
Reinsurance assets	–	993.8	371.4	5.6	–	1.0	1,371.8
Insurance and other receivables[1]	–	19.3	13.7	9.4	–	895.4	937.8
Derivative assets	–	6.6	32.8	40.3	–	–	79.7
Infrastructure debt	–	–	83.7	220.5	32.8	–	337.0
Commercial real estate loans	13.8	20.4	41.1	4.4	–	–	79.7
Cash and cash equivalents[2]	999.5	0.4	88.9	77.3	–	–	1,166.1
Total	1,013.3	1,040.5	631.6	357.5	32.8	896.4	3,972.1

Notes:
1. Includes receivables due from policyholders, agents, brokers and intermediaries which generally do not have a credit rating.
2. This represents money market funds with no notice period for withdrawal and cash at bank and in hand.

3. Risk management continued

3.3.4 Operational risk

This is the risk of loss due to inadequate or failed internal processes, people, systems, or from external events. Sources of operational risk for the Group include:

Change risk
This is the risk of failing to manage the Group's change portfolio resulting in conflicting priorities and failure to deliver strategic outcomes to time, cost or quality.

Technology and infrastructure risk
This is the risk that the IT infrastructure is insufficient to deliver the Group's strategy.

Outsourcing risk
This is the risk of failing to implement a robust framework for the sourcing, appointment and ongoing contract management of third party suppliers, outsourced service providers and intragroup relationships. This includes both domestic and offshore outsourcing activities.

Information Security risk
This is the risk of loss, corruption to Group or customer data, intellectual property or failure of business critical systems resulting in reputational damage, regulatory censure, supervision, fines and / or loss of competitive advantage.

The Group has in place agreed policies and standards to establish key controls relating to operational risk.

3.3.5 Liquidity risk

This is the risk of being unable to realise investments in order to settle financial obligations when they fall due.

The measurement and management of liquidity risk within the Group is undertaken within the limits and other policy parameters of the Group's liquidity risk appetite and is detailed within the liquidity risk minimum standard. As part of this process the Investment and Treasury team are required to put in place a liquidity plan which must consider expected and stressed scenarios for cash in-flows and out-flows that is reviewed at least annually by the Investment risk Committee. Compliance is monitored in respect of both the minimum standard and the regulatory requirements of the PRA.

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

	Notional amounts	Maturity and fair value			
At 31 December 2017	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	2,735.3	51.1	–	–	51.1
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	17.3	1.0	–	–	1.0
Interest rate swaps	1,794.9	(1.9)	21.5	12.7	32.3
Total	4,547.5	50.2	21.5	12.7	84.4

	Notional amounts	Maturity and fair value			
At 31 December 2017	£m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	579.9	11.3	–	–	11.3
Designated as hedging instruments:					
Interest rate swaps	113.1	0.5	(0.1)	0.3	0.7
Total	693.0	11.8	(0.1)	0.3	12.0

At 31 December 2016	Notional amounts £m	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	1,110.0	21.4	–	–	21.4
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	14.8	1.6	0.1	–	1.7
Interest rate swaps	1,902.0	(1.1)	3.0	54.7	56.6
Total	3,026.8	21.9	3.1	54.7	79.7

At 31 December 2016	Notional amounts £m	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	2,589.6	43.5	–	–	43.5
Designated as hedging instruments:					
Interest rate swaps	634.8	1.1	–	0.5	1.6
Total	3,224.4	44.6	–	0.5	45.1

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

At 31 December 2017	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Debt securities	**4,555.0**	492.5	1,017.9	1,109.5	1,710.2	224.9
Infrastructure debt	**316.4**	13.0	30.9	29.8	94.4	148.3
Commercial real estate loans	**169.0**	4.3	56.6	108.1	–	–
Cash and cash equivalents[1]	**1,358.6**	1,358.6	–	–	–	–
Total	**6,399.0**	**1,868.4**	**1,105.4**	**1,247.4**	**1,804.6**	**373.2**

At 31 December 2017	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	**264.7**	4.2	–	260.5	–	–
Insurance liabilities[2]	**4,225.7**	1,177.9	1,062.4	570.6	559.3	855.5
Borrowings	**54.1**	54.1	–	–	–	–
Trade and other payables, including insurance payables	**658.0**	648.8	8.0	0.4	0.8	–
Total	**5,202.5**	**1,885.0**	**1,070.4**	**831.5**	**560.1**	**855.5**

At 31 December 2016	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Debt securities	4,730.3	588.3	1,001.0	1,172.5	1,676.3	292.2
Infrastructure debt	337.0	13.1	24.6	28.0	87.0	184.3
Commercial real estate loans	79.7	1.3	32.6	45.8	–	–
Cash and cash equivalents[1]	1,166.1	1,166.1	–	–	–	–
Total	6,313.1	1,768.8	1,058.2	1,246.3	1,763.3	476.5

3. Risk management continued

At 31 December 2016	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	539.6	8.3	–	–	531.3	–
Insurance liabilities[2]	4,666.6	1,283.6	1,139.5	621.6	666.4	955.5
Borrowings	55.3	55.3	–	–	–	–
Trade and other payables, including insurance payables	699.2	688.9	9.8	0.2	0.3	–
Total	5,960.7	2,036.1	1,149.3	621.8	1,198.0	955.5

Notes:
1. This represents money market funds with no notice period for withdrawal and cash at bank and in hand.
2. Insurance liabilities exclude unearned premium reserves as there are no liquidity risks inherent in them.

3.4 Capital adequacy (unaudited)

The Group manages capital in accordance with the Group's capital management minimum standard, the aims of which are to manage capital efficiently and generate long-term sustainable value for shareholders, while balancing operational, regulatory, rating agency and policyholder requirements. The Group seeks to hold capital resources such that in the normal course of business, the Solvency II capital coverage ratio is around the middle of the target range of 140% to 180%.

The Group's regulatory capital position is assessed against the Solvency II framework. From 1 July 2016, the Group gained approval to assess its SCR using a partial internal model, including a full internal economic capital model for the UKI underwriting entity. The model is calibrated to a 99.5% confidence interval and considers business written to date and one year of future written business over a one year time horizon, in line with Solvency II requirements.

Using the Group's partial internal model, there is a capital surplus of approximately £0.86 billion above an estimated SCR of £1.39 billion as at 31 December 2017 (31 December 2016: £0.91 billion and £1.40 billion respectively). The Group's capital requirements and solvency position are produced and presented to the Board on a regular basis.

4. Segmental analysis

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

Motor

This segment consists of personal motor insurance together with the associated legal protection cover. The Group sells motor insurance direct to customers through its own brands, Direct Line, Churchill and Privilege, and also through partnership brands such as vehicle manufacturers and through PCWs.

Home

This segment consists of home insurance together with associated legal protection cover. The Group sells home insurance direct through its own brands, Direct Line, Churchill and Privilege, and also through partnership brands and through PCWs.

Rescue and other personal lines

This segment consists of rescue products which are sold direct through the Group's own brand, Green Flag, and other personal lines insurance, including travel, pet and creditor sold through its own brands, Direct Line, Churchill and Privilege, and also through partnership brands and through PCWs.

Commercial

This segment consists of commercial insurance for SME entities sold through NIG who distribute through proxies, Direct Line for Business which sells direct to SMEs, Churchill for Business and through partnership brands.

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

Run-off

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

Restructuring costs

Restructuring costs are costs incurred in respect of the business activities where the Group has a constructive obligation to restructure its activities.

No inter-segment transactions occurred in the year ended 31 December 2017 (2016: £nil). If any transaction were to occur, transfer prices between operating segments would be set on an arm's length basis in a manner similar to transactions with third parties. Segment income, expenses and results will include those transfers between business segments which will then be eliminated on consolidation.

During 2018 the Group does not expect to incur material restructuring costs and run-off profits are expected to decrease over time. From 2018 these items will be included within operating profit with any future material restructuring activities or other one-off items highlighted separately as they occur.

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

The table below analyses the Group's revenue and results by reportable segment for the year ended 31 December 2017.

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	**Total Ongoing £m**	Run-off £m	**Total £m**
Gross written premium	1,670.4	799.1	421.1	501.5	**3,392.1**	–	**3,392.1**
Gross earned premium	1,603.0	819.4	419.2	498.1	**3,339.7**	–	**3,339.7**
Reinsurance premium	(132.4)	(28.9)	(1.6)	(41.8)	**(204.7)**	–	**(204.7)**
Net earned premium	1,470.6	790.5	417.6	456.3	**3,135.0**	–	**3,135.0**
Investment return	117.2	21.1	4.6	31.8	**174.7**	0.7	**175.4**
Instalment income	85.3	23.1	2.1	5.9	**116.4**	–	**116.4**
Other operating income	43.0	0.9	12.9	6.1	**62.9**	–	**62.9**
Total income	1,716.1	835.6	437.2	500.1	**3,489.0**	0.7	**3,489.7**
Insurance claims	(799.2)	(403.3)	(273.8)	(176.9)	**(1,653.2)**	82.1	**(1,571.1)**
Insurance claims (payable to) / recoverable from reinsurers	(96.8)	2.8	0.5	(50.6)	**(144.1)**	(39.0)	**(183.1)**
Net insurance claims	(896.0)	(400.5)	(273.3)	(227.5)	**(1,797.3)**	43.1	**(1,754.2)**
Commission expenses	(36.7)	(139.7)	(22.9)	(87.1)	**(286.4)**	–	**(286.4)**
Operating expenses	(418.9)	(166.6)	(97.4)	(111.5)	**(794.4)**	–	**(794.4)**
Total expenses	(455.6)	(306.3)	(120.3)	(198.6)	**(1,080.8)**	–	**(1,080.8)**
Operating profit before restructuring	**364.5**	**128.8**	**43.6**	**74.0**	**610.9**	**43.8**	**654.7**
Restructuring costs							**(11.9)**
Operating profit							**642.8**
Finance costs							**(103.8)**
Profit before tax							**539.0**
Underwriting profit	**119.0**	**83.7**	**24.0**	**30.2**	**256.9**		
Loss ratio	60.9%	50.6%	65.4%	49.9%	**57.4%**		
Commission ratio	2.5%	17.7%	5.5%	19.1%	**9.1%**		
Expense ratio	28.5%	21.1%	23.4%	24.4%	**25.3%**		
COR	**91.9%**	**89.4%**	**94.3%**	**93.4%**	**91.8%**		

The table below analyses the Group's assets and liabilities by reportable segment at 31 December 2017.

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	Run-off £m	**Total £m**
Goodwill	127.7	45.8	28.7	10.1	–	**212.3**
Other segment assets	6,654.8	708.8	204.3	1,525.1	642.7	**9,735.7**
Segment liabilities	(4,664.6)	(496.8)	(143.2)	(1,069.0)	(512.8)	**(6,886.4)**
Segment net assets	**2,117.9**	**257.8**	**89.8**	**466.2**	**129.9**	**3,061.6**

The segmental analysis of assets and liabilities is prepared using a combination of asset and liability balances directly attributable to each operating segment and an apportionment of assets and liabilities managed at a Group wide level. This does not represent the Group's view of the capital requirements for its operating segments.

4. Segmental analysis continued

The table below analyses the Group's revenue and results by reportable segment for the year ended 31 December 2016.

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	Total Ongoing £m	Run-off £m	Total £m
Gross written premium	1,539.1	834.4	400.8	499.8	3,274.1	–	3,274.1
Gross earned premium	1,461.3	851.0	396.1	494.4	3,202.8	–	3,202.8
Reinsurance premium	(124.2)	(34.7)	(1.7)	(41.6)	(202.2)	–	(202.2)
Net earned premium	1,337.1	816.3	394.4	452.8	3,000.6	–	3,000.6
Investment return	116.9	19.9	3.9	27.4	168.1	3.4	171.5
Instalment income	76.1	23.5	1.9	5.6	107.1	–	107.1
Other operating income	40.9	0.8	13.5	3.0	58.2	–	58.2
Total income	1,571.0	860.5	413.7	488.8	3,334.0	3.4	3,337.4
Insurance claims	(1,297.3)	(332.1)	(243.0)	(297.7)	(2,170.1)	(8.9)	(2,179.0)
Insurance claims recoverable from reinsurers	295.6	0.1	–	47.2	342.9	32.3	375.2
Net insurance claims	(1,001.7)	(332.0)	(243.0)	(250.5)	(1,827.2)	23.4	(1,803.8)
Commission expenses	(42.9)	(184.4)	(28.4)	(88.3)	(344.0)	–	(344.0)
Operating expenses	(377.3)	(177.4)	(96.4)	(108.2)	(759.3)	(0.2)	(759.5)
Total expenses	(420.2)	(361.8)	(124.8)	(196.5)	(1,103.3)	(0.2)	(1,103.5)
Operating profit before restructuring	149.1	166.7	45.9	41.8	403.5	26.6	430.1
Restructuring costs							(39.9)
Operating profit							390.2
Finance costs							(37.2)
Profit before tax							353.0
Underwriting (loss) / profit	(84.8)	122.5	26.6	5.8	70.1		
Loss ratio	74.9%	40.7%	61.6%	55.3%	60.9%		
Commission ratio	3.2%	22.6%	7.2%	19.5%	11.5%		
Expense ratio	28.2%	21.7%	24.5%	23.9%	25.3%		
COR	106.3%	85.0%	93.3%	98.7%	97.7%		

The table below analyses the Group's assets and liabilities by reportable segment at 31 December 2016.

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	Run-off £m	Total £m
Goodwill	126.7	45.8	28.7	10.1	–	211.3
Other segment assets	6,748.9	660.5	160.4	1,587.4	753.2	9,910.4
Other segment liabilities	(5,131.7)	(502.2)	(122.0)	(1,207.0)	(637.3)	(7,600.2)
Segment net assets	1,743.9	204.1	67.1	390.5	115.9	2,521.5

The segmental analysis of assets and liabilities is prepared using a combination of asset and liability balances directly attributable to each operating segment and an apportionment of assets and liabilities managed at a Group wide level. This does not represent the Group's view of the capital requirements for its operating segments.

5. Net earned premium

	2017 £m	2016 £m
Gross earned premium:		
Gross written premium	3,392.1	3,274.1
Movement in unearned premium reserve	(52.4)	(71.3)
	3,339.7	3,202.8
Reinsurance premium:		
Premium payable	(208.4)	(206.2)
Movement in reinsurance unearned premium reserve	3.7	4.0
	(204.7)	(202.2)
Total	3,135.0	3,000.6

6. Investment return

	2017 £m	2016 £m
Investment income:		
Interest income from debt securities	137.5	136.5
Cash and cash equivalent interest income	3.0	4.2
Interest income from infrastructure debt	6.8	7.8
Interest income from commercial real estate loans	3.6	1.0
Interest income	150.9	149.5
Rental income from investment property	16.2	18.4
	167.1	167.9
Net realised gains / (losses):		
AFS debt securities	23.2	15.3
Derivatives	175.0	(282.3)
Investment property (note 19)	1.6	1.3
	199.8	(265.7)
Net unrealised (losses) / gains:		
Impairment of loans and receivables	(9.5)	–
Derivatives	(202.0)	265.2
Investment property (note 19)	20.0	4.1
	(191.5)	269.3
Total	175.4	171.5

The table below analyses the realised and unrealised gains and losses on derivative instruments included in investment return.

	Realised 2017 £m	Unrealised 2017 £m	Realised 2016 £m	Unrealised 2016 £m
Derivative gains / (losses):				
Foreign exchange forward contracts[1]	107.8	62.5	(425.7)	19.1
Associated foreign exchange risk	68.4	(259.1)	151.0	253.0
Net gains / (losses) on foreign exchange forward contracts	176.2	(196.6)	(274.7)	272.1
Interest rate swaps[1]	1.8	(1.7)	(16.9)	20.7
Associated interest rate risk on hedged items	(3.0)	(3.7)	9.3	(27.6)
Net losses on interest rate derivatives	(1.2)	(5.4)	(7.6)	(6.9)
Total	175.0	(202.0)	(282.3)	265.2

Note:
1. Foreign exchange forward contracts are at fair value through the income statement and interest rate swaps are designated as hedging instruments.

7. Other operating income

	2017 £m	2016 £m
Vehicle replacement referral income	16.9	14.1
Revenue from vehicle recovery and repair services	11.3	19.3
Legal services income	11.0	11.2
Other income[1]	23.7	13.6
Total	62.9	58.2

Note:
1. Other income includes salvage income and fee income from insurance intermediary services.

8. Net insurance claims

	Gross	Reinsurance	Net	Gross	Reinsurance	Net
	2017 £m	2017 £m	2017 £m	2016 £m	2016 £m	2016 £m
Current accident year claims paid	1,165.0	(0.2)	1,164.8	1,131.7	–	1,131.7
Prior accident year claims paid	847.0	(13.8)	833.2	905.2	(18.8)	886.4
(Decrease) / increase in insurance liabilities	(440.9)	197.1	(243.8)	142.1	(356.4)	(214.3)
Total	1,571.1	183.1	1,754.2	2,179.0	(375.2)	1,803.8

The table below analyses the claims handling expenses included in the net insurance claims.

	2017 £m	2016 £m
Ongoing operations	175.0	164.4
Run-off	(0.2)	1.2
Total	174.8	165.6

9. Commission expenses

	2017 £m	2016 £m
Commission expenses	225.4	246.8
Expenses incurred under profit participations	61.0	97.2
Total	286.4	344.0

10. Operating expenses

	Total Ongoing	Restructuring costs	Run-off	Total Group
	2017 £m	2017 £m	2017 £m	2017 £m
Staff costs[1]	268.6	11.5	–	280.1
Other operating expenses[1,2]	273.2	0.4	–	273.6
Marketing	113.7	–	–	113.7
Amortisation and impairment of other intangible assets	111.0	–	–	111.0
Depreciation	27.9	–	–	27.9
Total	794.4	11.9	–	806.3

Notes:
1. Staff costs and other operating expenses attributable to claims handling activities are allocated to the cost of insurance claims.
2. Other operating expenses include IT costs, insurance levies, professional fees and property costs.

	Total Ongoing 2016 £m	Restructuring costs 2016 £m	Run-off 2016 £m	Total Group 2016 £m
Staff costs[1]	269.0	16.0	–	285.0
Other operating expenses[1,2,3]	250.9	23.9	0.2	275.0
Marketing	112.6	–	–	112.6
Amortisation and impairment of other intangible assets	96.7	–	–	96.7
Depreciation	30.1	–	–	30.1
Total	759.3	39.9	0.2	799.4

Notes:

1. Staff costs and other operating expenses attributable to claims handling activities are allocated to the cost of insurance claims.
2. Other operating expenses include IT costs, insurance levies, professional fees and property costs.
3. A property site in Bristol comprising of freehold property and fixtures and fittings was transferred from freehold property to assets held for sale in 2016. The property with a carrying value of £23.5 million was remeasured on transfer to its fair value of £3.8 million resulting in a charge to other operating expenses in restructuring of £19.7 million.

The table below analyses the number of people employed by the Group's operations.

	At 31 December		Average for the year	
	2017	2016	**2017**	2016
Operations	**9,539**	9,692	**9,669**	9,546
Support	**1,269**	1,285	**1,280**	1,353
Total	**10,808**	10,977	**10,949**	10,899

The aggregate remuneration of those employed by the Group's operations comprised:

	2017 £m	2016 £m
Wages and salaries	**363.6**	348.1
Social security costs	**40.4**	38.9
Pension costs	**25.5**	24.4
Share-based payments	**14.8**	16.8
Total	**444.3**	428.2

The table below analyses Auditor's remuneration in respect of the Group's operations.

	2017 £m	2016 £m
Fees payable for the audit of:		
The Company's annual accounts	**0.3**	0.3
The Company's subsidiaries	**1.6**	1.5
Total audit fees	**1.9**	1.8
Fees payable for non-audit services:		
Audit-related assurance services	**0.1**	0.2
Other services	**0.1**	0.2
Total non-audit services	**0.2**	0.4
Total	**2.1**	2.2

10. Operating expenses continued

Aggregate Directors' emoluments

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

	2017 £m	2016 £m
Salaries, fees, bonuses and benefits in kind	5.6	3.1
Gains on exercise of share options	5.3	3.5
Total	10.9	6.6

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

At 31 December 2017, no Directors (2016: one Director) had retirement benefits accruing under the defined contribution pension scheme in respect of qualifying service. During the year ended 31 December 2017, three Directors exercised share options (2016: one Director).

11. Finance costs

	2017 £m	2016 £m
Interest expense on subordinated liabilities	44.8	46.3
Net interest received on designated hedging instrument[1]	(8.0)	(8.0)
Unrealised loss / (gain) on designated hedging instrument[1]	10.4	(19.6)
Unrealised (gain) / loss on associated interest rate risk on hedged item[1]	(11.7)	17.8
Realised gain on associated interest rate risk on hedged item[1]	(11.3)	–
Premium paid to repurchase subordinated liabilities and associated transaction costs	77.4	–
Amortisation of arrangement costs and discount on issue of subordinated liabilities	2.2	0.7
Total	103.8	37.2

Note:

1. As described in note 32, on 27 April 2012 the Group issued subordinated guaranteed dated notes with a nominal value of £500 million at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year designated hedging instrument to exchange the fixed rate of interest on the notes for a floating rate of three-month LIBOR plus a spread of 706 basis points, which increased to 707 basis points with effect from 29 July 2013. On 8 December 2017, the Group redeemed £250 million nominal value of the notes.

12. Tax charge

	2017 £m	2016 £m
Current taxation:		
Charge for the year	114.4	84.4
Under / (over) provision in respect of prior year[1]	5.3	(7.7)
	119.7	76.7
Deferred taxation (note 13):		
Credit for the year	(5.8)	(5.1)
(Over) / under provision in respect of prior year	(8.9)	2.6
	(14.7)	(2.5)
Current taxation	119.7	76.7
Deferred taxation (note 13)	(14.7)	(2.5)
Tax charge for the year	105.0	74.2

Note:

1. The prior year current tax credit for the year ended 31 December 2016 included £5.6 million relating to retrospective claims for research and development tax relief.

The following table analyses the difference between the actual income tax charge and the expected income tax charge computed by applying the standard rate of corporation tax of 19.25%[1] (2016: 20.0%).

	2017 £m	2016 £m
Profit before tax	539.0	353.0
Expected tax charge	103.8	70.6
Effects of:		
Disallowable expenses	5.4	10.6
Non-taxable items	(0.3)	(0.9)
Effect of change in corporation taxation rate	(0.2)	(1.0)
Over provision in respect of prior year	(3.7)	(5.1)
Tax charge for the year	105.0	74.2
Effective income tax rate	19.5%	21.0%

Note:

1. In the Finance (No 2) Act 2015 the UK Government enacted a reduction in the UK corporation tax rate from 20% to 19% effective from 1 April 2017, and then the Finance Act 2016 enacted a further reduction to 17% effective from 1 April 2020. As a consequence, the closing deferred tax assets and liabilities have been recognised at the tax rates expected to apply when the assets or liabilities are settled. The impact of these changes on the tax charge for the year is set out in the table above.

13. Current and deferred tax

.	2017 £m	2016 £m
Per balance sheet:		
Current tax assets	0.1	0.1
Current tax liabilities	(40.7)	(0.5)
Deferred tax liabilities	(31.1)	(46.0)

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

	Provisions and other temporary differences £m	Retirement benefit obligations £m	Depreciation in excess of capital allowances £m	Non-distributable reserve[1] £m	Investment properties £m	Share-based payments £m	AFS revaluation reserve £m	Total £m
At 1 January 2016	3.3	(2.4)	0.8	(28.9)	(8.4)	5.7	–	(29.9)
(Charge) / credit to the income statement	(0.7)	(0.4)	(1.8)	5.5	0.2	(0.3)	–	2.5
Credit / (charge) to other comprehensive income	–	0.7	–	–	–	–	(18.0)	(17.3)
Charge direct to equity	–	–	–	–	–	(1.3)	–	(1.3)
At 31 December 2016	2.6	(2.1)	(1.0)	(23.4)	(8.2)	4.1	(18.0)	(46.0)
Credit to the income statement	–	–	1.5	4.8	8.2	0.2	–	14.7
(Charge) / credit to other comprehensive income	–	(0.4)	–	–	–	–	2.2	1.8
Charge direct to equity	–	–	–	–	–	(1.0)	–	(1.0)
Other movements	(0.6)	–	–	–	–	–	–	(0.6)
At 31 December 2017	2.0	(2.5)	0.5	(18.6)	–	3.3	(15.8)	(31.1)

Note:

1. The non-distributable reserve was a statutory claims equalisation reserve calculated in accordance with the rules of the PRA. With the introduction of Solvency II on 1 January 2016, the requirement to maintain this reserve ceased and the balance at 31 December 2015 was released to retained earnings. The taxation of this release is spread over six years from the change in regulation. This is provided for in deferred tax above as it represents the future unwind of previously claimed tax deductions for transfers into this reserve.

In addition, the Group has an unrecognised deferred tax asset at 31 December 2017 of £7.4 million (2016: £7.5 million) in relation to capital losses of which £4.1 million (2016: £4.1 million) relates to realised losses and £3.3 million (2016: £3.4 million) relates to unrealised losses.

14. Dividends

	2017 £m	2016 £m
Amounts recognised as distributions to equity holders in the period:		
2016 final dividend of 9.7 pence per share paid on 18 May 2017	132.4	–
2015 final dividend of 9.2 pence per share paid on 19 May 2016	–	126.0
2017 first interim dividend of 6.8 pence per share paid on 8 September 2017	92.9	–
2016 first interim dividend of 4.9 pence per share paid on 9 September 2016	–	67.1
2016 first special interim dividend of 10.0 pence per share paid on 9 September 2016	–	136.9
2015 second special interim dividend of 8.8 pence per share paid on 19 May 2016	–	120.6
	225.3	450.6
Proposed dividends:		
2017 final dividend of 13.6 pence per share	187.0	–
2017 special dividend of 15.0 pence per share	206.3	–
2016 final dividend of 9.7 pence per share	–	133.4

The proposed final and special dividends for 2017 have not been included as a liability in these financial statements.

The trustees of the employee share trusts waived their entitlement to dividends on shares held to meet obligations arising on the Long Term Incentive Plan, Deferred Annual Incentive Plan and Restrictive Share Plan awards, which reduced the total dividend paid for the year ended 31 December 2017 by £1.6 million (2016: £1.8 million).

15. Earnings per share

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

Basic

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

	2017 £m	2016 £m
Earnings attributable to owners of the Company	434.0	278.8
Weighted average number of Ordinary Shares (millions)	1,366.1	1,368.7
Basic earnings per share (pence)	31.8	20.4

Diluted

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

	2017 £m	2016 £m
Earnings attributable to owners of the Company	434.0	278.8
Weighted average number of Ordinary Shares (millions)	1,366.1	1,368.7
Effect of dilutive potential of share options and contingently issuable shares (millions)	12.9	13.1
Weighted average number of Ordinary Shares for the purpose of diluted earnings per share (millions)	1,379.0	1,381.8
Diluted earnings per share (pence)	31.5	20.2

16. Net assets per share and return on equity

Net asset value per share is calculated as total shareholders' equity divided by the number of Ordinary Shares at the end of the period excluding shares held by employee share trusts.

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

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

At 31 December	2017 £m	2016 £m
Net assets	2,715.1	2,521.5
Goodwill and other intangible assets[1]	(471.1)	(508.9)
Tangible net assets	2,244.0	2,012.6
Number of Ordinary Shares (millions)	1,375.0	1,375.0
Shares held by employee share trusts (millions)	(9.9)	(9.9)
Closing number of Ordinary Shares (millions)	1,365.1	1,365.1
Net asset value per share (pence)	198.9	184.7
Tangible net asset value per share (pence)	164.4	147.4

Note:

1. Goodwill has arisen on acquisition by the Group of subsidiary companies. Intangible assets are primarily comprised of software development costs.

Return on equity

The table below details the calculation of return on equity.

	2017 £m	2016 £m
Earnings attributable to owners of the Company	434.0	278.8
Opening shareholders' equity	2,521.5	2,630.0
Closing shareholders' equity	2,715.1	2,521.5
Average shareholders' equity	2,618.3	2,575.8
Return on equity	16.6%	10.8%

17. Goodwill and other intangible assets

	Goodwill £m	Other intangible assets £m	Total £m
Cost			
At 1 January 2016	211.0	495.2	706.2
Acquisitions and additions	0.3	80.5	80.8
Disposals and write-off[1]	–	(5.8)	(5.8)
At 31 December 2016	211.3	569.9	781.2
Acquisitions and additions	1.0	72.2	73.2
At 31 December 2017	212.3	642.1	854.4
Accumulated amortisation and impairment			
At 1 January 2016	–	181.4	181.4
Charge for the year	–	57.4	57.4
Disposals and write-off[1]	–	(5.8)	(5.8)
Impairment losses[2]	–	39.3	39.3
At 31 December 2016	–	272.3	272.3
Charge for the year	–	54.1	54.1
Impairment losses[2]	–	56.9	56.9
At 31 December 2017	–	383.3	383.3

Carrying amount			
At 31 December 2017	212.3	258.8	471.1
At 31 December 2016	211.3	297.6	508.9

Notes:

1. Disposals and write-off include fully amortised intangible assets no longer utilised by the Group in its operating activities.
2. The impairment losses relate to capitalised software development costs for ongoing IT projects primarily relating to development of new systems. The impairment losses result from capitalised costs that will no longer be utilised and the charge which reduced the carrying value of impaired assets to £nil, is reflected in the Motor segment.

17. Goodwill and other intangible assets continued

Goodwill arose on the acquisition of U K Insurance Limited (£141.0 million) and Churchill Insurance Company Limited (£70.0 million), which is allocated across Motor, Home, Rescue and other personal lines and Commercial. The addition to goodwill in the year ended 31 December 2017 of £1.0 million arose as a result of a business combination to expand the Group's accident repair centre network.

The Group's testing for goodwill impairment includes the comparison of the recoverable amount of each CGU to which goodwill has been allocated with its carrying value and updated at each reporting date in the event of indications of impairment.

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

	2017 £m	2016 £m
Motor	127.7	126.7
Home	45.8	45.8
Rescue and other personal lines	28.7	28.7
Commercial	10.1	10.1
Total	212.3	211.3

There have been no impairments in goodwill for the year ended 31 December 2017 (2016: £nil).

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

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

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

	Assumptions			Sensitivity: Impact on recoverable amount of a:		
CGU	Terminal growth rate %	Pre-tax discount rate %	Recoverable amount in excess of carrying value £m	1% decrease in terminal growth rate £m	1% increase in pre-tax discount rate £m	1% decrease in forecast pre-tax profit[1] £m
Motor	3.0	11.5	1058.8	(84.3)	(84.3)	(29.9)
Home	3.0	11.5	586.6	(60.4)	(82.9)	(8.0)
Rescue and other personal lines	3.0	11.5	556.6	(53.3)	(72.4)	(6.5)
Commercial	3.0	11.5	529.9	(74.0)	(100.6)	(9.1)

Note:
1. Reflects a 1% decrease in the profit for each year of the five-year plan.

18. Property, plant and equipment

	Freehold land and buildings £m	Other equipment £m	Total £m
Cost			
At 1 January 2016	79.0	187.8	266.8
Additions	18.8	31.1	49.9
Disposals	–	(14.3)	(14.3)
Transfer to assets held for sale (note 28)	(18.0)	(8.3)	(26.3)
At 31 December 2016	79.8	196.3	276.1
Additions	–	22.4	22.4
Disposals	–	(15.1)	(15.1)
At 31 December 2017	79.8	203.6	283.4
Accumulated depreciation and impairment			
At 1 January 2016	2.4	78.1	80.5
Depreciation charge for the year	1.0	29.1	30.1
Disposals	–	(12.6)	(12.6)
Transfer to assets held for sale (note 28)	(0.3)	(2.5)	(2.8)
At 31 December 2016	3.1	92.1	95.2
Depreciation charge for the year	1.1	26.8	27.9
Disposals	–	(14.1)	(14.1)
At 31 December 2017	4.2	104.8	109.0

Carrying amount			
At 31 December 2017	75.6	98.8	174.4
At 31 December 2016	76.7	104.2	180.9

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

19. Investment property

	2017 £m	2016 £m
At 1 January	329.0	347.4
Additions at cost	–	1.4
Increase in fair value during the year	21.6	5.4
Disposals	(41.3)	(25.2)
At 31 December	309.3	329.0

Note:

1. The cost included in carrying value at 31 December 2017 is £252.4 million (2016: £275.3 million).

The investment properties are measured at fair value derived from valuation work carried out at the balance sheet date by independent property valuers.

The valuation conforms to international valuation standards. The fair value was determined using a methodology based on recent market transactions for similar properties, which have been adjusted for the specific characteristics of each property within the portfolio. This approach to valuation is consistent with the methodology used in the year ended 31 December 2016.

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

20. Subsidiaries

The principal subsidiary undertakings of the Group, over which it exercises 100% voting power, are shown below. Their capital consists of Ordinary Shares which are unlisted. All subsidiaries (a full list of which is included in note 2 of the Parent Company's financial statements) are included in the Group's consolidated financial statements.

Name of subsidiary	Place of incorporation and operation	Principal activity
DL Insurance Services Limited	United Kingdom	Management services
U K Insurance Limited	United Kingdom	General insurance

The Group did not dispose of any subsidiaries in the years ended 31 December 2017 and 31 December 2016.

21. Reinsurance assets

	Notes	2017 £m	2016 £m
Reinsurers' share of general insurance liabilities		1,141.1	1,329.0
Impairment provision[1]		(59.9)	(50.7)
	33	1,081.2	1,278.3
Reinsurers' unearned premium reserve	34	97.3	93.5
Total		1,178.5	1,371.8

Note:

1. Impairment provision relates to reinsurance debtors allowing for the risk that reinsurance assets may not be collected or where the reinsurer's credit rating has been significantly downgraded and it may have difficulty in meeting its obligations.

Movements in reinsurance asset impairment provision

	2017 £m	2016 £m
At 1 January	(50.7)	(53.9)
Additional provision	(9.6)	(4.2)
Release to income statement	0.4	7.4
At 31 December	(59.9)	(50.7)

22. Deferred acquisition costs

	2017 £m	2016 £m
At 1 January	203.1	203.8
Net decrease in the year	(17.7)	(0.7)
At 31 December	185.4	203.1

23. Insurance and other receivables

	2017 £m	2016 £m
Receivables arising from insurance contracts:		
Due from policyholders	840.4	820.8
Impairment provision of policyholder receivables	(1.2)	(0.3)
Due from agents, brokers and intermediaries	71.3	66.4
Impairment provision of agent, broker and intermediary receivables	(0.9)	(1.0)
Other debtors	71.6	102.4
Total	981.2	988.3

24. Derivative financial instruments

	2017 £m	2016 £m
Derivative assets		
At fair value through the income statement:		
Foreign exchange contracts (forwards)	51.1	21.4
Designated as hedging instruments:		
Foreign exchange contracts (forwards)[1]	1.0	1.7
Interest rate swaps	32.3	56.6
Total	84.4	79.7
Derivative liabilities		
At fair value through the income statement:		
Foreign exchange contracts (forwards)	11.3	43.5
Designated as hedging instruments:		
Interest rate swaps	0.7	1.6
Total	12.0	45.1

Note:
1. Cash flow hedges in relation to supplier payments.

25. Retirement benefit obligations

Defined contribution scheme

The pension charge in respect of the defined contribution scheme for the year ended 31 December 2017 was £25.5 million (2016: £24.9 million).

Defined benefit scheme

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

The weighted average duration of the defined benefit obligations at 31 December 2017 is 20 years (2016: 20 years) using accounting assumptions.

The table below sets out the principal assumptions used in determining the defined benefit scheme obligations.

	2017 %	2016 %
Rate of increase in pension payment	2.2	2.2
Rate of increase of deferred pensions	2.2	2.2
Discount rate	2.5	2.7
Inflation rate	3.3	3.3

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

Post-retirement mortality assumptions

	2017	2016
Life expectancy at age 60 now:		
Males	87.5	88.1
Females	89.2	90.1
Life expectancy at age 60 in 20 years' time:		
Males	89.3	90.3
Females	91.1	92.5

25. Retirement benefit obligations continued

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

	2017 £m	2016 £m
Index-linked bonds	28.7	28.6
Government bonds	17.7	16.9
Liquidity fund[1]	52.7	56.3
Other	2.6	0.7
Total	101.7	102.5

Note:

1. The liquidity fund is an investment in an open-ended fund incorporated in the Republic of Ireland which targets capital stability and income in the UK. It is invested in short-term fixed income and variable rate securities (such as Treasury Bills) listed or traded on one or more recognised exchange.

The majority of debt instruments held directly or through the liquidity fund have quoted prices in active markets.

Movement in net pension surplus

	Fair value of defined benefit scheme assets £m	Present value of defined benefit scheme obligations £m	Net pension surplus £m
At 1 January 2016	85.1	(72.0)	13.1
Income statement:			
Net interest income / (cost)[1]	3.2	(2.7)	0.5
Statement of comprehensive income:			
Actuarial gains arising from experience adjustments	13.7	1.2	14.9
Actuarial losses arising from changes in financial assumptions	–	(19.3)	(19.3)
Contributions by employer	2.8	–	2.8
Benefits paid	(2.3)	2.3	–
At 31 December 2016	102.5	(90.5)	12.0
Income statement:			
Net interest income / (cost)[1]	2.7	(2.4)	0.3
Statement of comprehensive income:			
Actuarial gains arising from experience adjustments	1.0	1.5	2.5
Actuarial gains arising from changes in demographic assumptions	–	3.1	3.1
Actuarial losses arising from changes in financial assumptions	–	(3.5)	(3.5)
Benefits paid	(4.5)	4.5	–
At 31 December 2017	101.7	(87.3)	14.4

Note:

1. The net interest income / (cost) in the income statement has been included under other operating expenses.

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

	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m
Present value of defined benefit scheme obligations	(87.3)	(90.5)	(72.0)	(79.6)	(68.0)
Fair value of defined benefit scheme assets	101.7	102.5	85.1	83.1	66.0
Net surplus / (deficit)	14.4	12.0	13.1	3.5	(2.0)
Experience adjustment gains / (losses) on scheme liabilities	1.5	1.2	1.2	1.0	(0.2)
Experience adjustment gains / (losses) on scheme assets	1.0	13.7	(1.9)	12.9	(1.3)

Sensitivity analysis

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

	Impact on pension cost		Impact on present value of defined benefit scheme obligations	
	2017 £m	2016 £m	2017 £m	2016 £m
Discount rate				
0.25% increase in discount rate	(0.2)	(0.2)	(4.4)	(4.7)
0.25% decrease in discount rate	0.1	0.1	4.4	4.7
Inflation rate				
0.25% increase in inflation rate	–	–	2.2	2.3
0.25% decrease in inflation rate	–	–	(2.2)	(2.3)
Life expectancy				
1 year increase in life expectancy	0.1	0.1	3.1	2.7
1 year decrease in life expectancy	(0.1)	(0.1)	(3.1)	(2.7)

The most recent funding valuation of the Group's defined benefit scheme was carried out as at 1 October 2014. The Group agreed with the trustees to make a contribution of £2.8 million in 2016 with further contributions of up to £1.5 million per annum in 2017 and 2018 to meet the scheme's funding requirements. As a result of a funding update, no contributions are expected to be payable in 2018 (2017: £nil). The Group is currently undertaking a funding valuation of the defined benefit scheme as at 1 October 2017, the results of which are due to be agreed with the trustees in 2018.

26. Financial investments

	2017 £m	2016 £m
AFS debt securities		
Corporate	4,170.5	4,183.7
Supranational	43.9	98.6
Local government	12.2	21.7
Sovereign	224.8	341.2
Total	4,451.4	4,645.2
HTM debt securities		
Corporate	103.6	85.1
Total debt securities	4,555.0	4,730.3
Total debt securities		
Fixed interest rate[1]	4,540.1	4,709.6
Floating interest rate	14.9	20.7
Total	4,555.0	4,730.3
Loans and receivables		
Infrastructure debt	316.4	337.0
Commercial real estate loans	169.0	79.7
Total	5,040.4	5,147.0

Note:

1. The Group swaps a fixed interest rate for a floating rate of interest on its US Dollar, Euro and a small amount of its sterling corporate debt securities by entering into interest rate derivatives. The hedged amount at 31 December 2017 was £1,591.5 million (2016: £1,593.6 million).

27. Cash and cash equivalents and borrowings

	2017 £m	2016 £m
Cash at bank and in hand	258.0	166.6
Short-term deposits with credit institutions[1]	1,100.6	999.5
Cash and cash equivalents	1,358.6	1,166.1
Bank overdrafts[2]	(54.1)	(55.3)
Cash and bank overdrafts[3]	1,304.5	1,110.8

Notes:

1. This represents money market funds with no notice period for withdrawal.
2. Bank overdrafts represent short-term timing differences between transactions posted in the records of the Group and transactions flowing through the accounts at the bank.
3. Cash and bank overdrafts disclosure note is included for the purposes of the consolidated cash flow statement.

The effective interest rate on short-term deposits with credit institutions for the year ended 31 December 2017 was 0.29% (2016: 0.45%) and average maturity was 10 days (2016: 10 days).

28. Assets held for sale

	2017 £m	2016 £m
Freehold property held for sale[1]	4.2	3.8

Note:

1. The freehold property held for sale at 31 December 2017 relates to Bristol Broad Street which was transferred from property, plant and equipment to assets held for sale in 2016. The fair value change in 2017 relates to estimated costs to sell.

29. Share capital

	2017 Number millions	2016 Number millions	2017 £m	2016 £m
Issued and fully paid: equity shares				
Ordinary Shares of 10 10/11 pence each[1]	1,375	1,375	150.0	150.0

Note:

1. The shares have attached to them full voting dividend and capital distribution rights (including wind-up); they do not confer any rights of redemption.

Employee trust shares

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

At 31 December 2017, 9,945,473 Ordinary Shares (2016: 9,946,340 Ordinary Shares) were owned by the employee share trusts with a cost of £34.1 million (2016: £34.3 million). These Ordinary Shares are carried at cost and have a market value of £38.0 million (2016: £36.7 million).

30. Other reserves

Movements in the revaluation reserve for AFS investments

	2017 £m	2016 £m
At 1 January	92.1	5.4
Revaluation during the year – gross	8.8	119.6
Revaluation during the year – tax	(1.5)	(20.2)
Realised gains – gross	(23.2)	(15.3)
Realised gains – tax	4.0	2.6
At 31 December	80.2	92.1

Capital reserves

	2017 £m	2016 £m
Capital contribution reserve[1]	100.0	100.0
Capital redemption reserve[2]	1,350.0	1,350.0
Total	1,450.0	1,450.0

Notes:

1. Arose on the cancellation of a debt payable to a shareholder.
2. Arose on the reduction of nominal value of each share in issue with a corresponding transfer to capital redemption reserve.

31. Tier 1 notes

	2017 £m	2016 £m
Tier 1 notes	346.5	–

On 7 December 2017, the Group issued £350 million of fixed rate perpetual Tier 1 notes with a coupon rate of 4.75% per annum.

The Group has an optional redemption date of 7 December 2027. If the notes are not repaid on that date, a fixed rate of interest per annum will be reset. The notes are direct, unsecured and subordinated obligations of the issuer ranking pari passu and without any preference amongst themselves.

The Tier1 notes are treated as a separate category within equity and the coupon payments are recognised outside of the profit after tax result and directly in shareholders' equity.

The Group has the option to cancel the coupon payment which becomes mandatory upon breach or non-compliance with the Group SCR, a breach of the minimum capital requirement or where the Group has insufficient distributable reserves.

Proceeds of this issuance have primarily been used to fund the repurchase of £250 million subordinated guaranteed dated notes which had a market value of £326.8 million (see note 32).

32. Subordinated liabilities

	2017 £m	2016 £m
Subordinated guaranteed dated notes	264.7	539.6

The subordinated guaranteed dated notes with a nominal value of £500 million were issued on 27 April 2012 at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year designated hedging instrument to exchange the fixed rate of interest for a floating rate of three-month LIBOR plus a spread of 706 basis points which was credit value adjusted to 707 basis points with effect from 29 July 2013.

On 8 December 2017, the Group repurchased £250 million nominal value of the subordinated guaranteed dated notes for a purchase price of £330.1 million including accrued interest of £2.7 million and associated transaction costs of £0.6 million.

The remaining notes, with a nominal value of £250 million, have a redemption date of 27 April 2042 with the option to repay the notes on 27 April 2022. If the notes are not repaid on that date, the rate of interest will be reset at a rate of the six-month LIBOR plus 7.91%.

The Group has the option, in certain circumstances, to defer interest payments on the notes but to date has not exercised this right.

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

33. Insurance liabilities

	2017 £m	2016 £m
Insurance liabilities	4,225.7	4,666.6

Gross insurance liabilities

Accident year	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	Total £m
Estimate of ultimate gross claims costs:											
At end of accident year	3,393.4	3,823.3	3,941.7	2,698.1	2,372.7	2,184.0	2,094.5	2,118.1	2,157.7	2,217.3	
One year later	50.8	121.6	(117.1)	(99.3)	(163.3)	(117.6)	20.7	(30.0)	(86.7)		
Two years later	51.7	(37.0)	(99.1)	(94.6)	(118.9)	(153.0)	(38.4)	(143.5)			
Three years later	(36.7)	(14.0)	(50.3)	(89.3)	(49.3)	(21.0)	(144.9)				
Four years later	(16.7)	(101.5)	(105.5)	(60.9)	(9.9)	(102.1)					
Five years later	(55.5)	(38.8)	(57.7)	(21.2)	(79.2)						
Six years later	(45.7)	(80.8)	(25.9)	(60.3)							
Seven years later	(29.9)	(27.3)	(50.0)								
Eight years later	(16.2)	(14.0)									
Nine years later	(24.3)										
Current estimate of cumulative claims	3,270.9	3,631.5	3,436.1	2,272.5	1,952.1	1,790.3	1,931.9	1,944.6	2,071.0	2,217.3	
Cumulative payments to date	(3,181.5)	(3,469.5)	(3,303.7)	(2,153.9)	(1,843.0)	(1,610.0)	(1,526.7)	(1,469.7)	(1,442.4)	(1,050.6)	
Gross liability recognised in balance sheet	89.4	162.0	132.4	118.6	109.1	180.3	405.2	474.9	628.6	1,166.7	3,467.2
2007 and prior											679.2
Claims handling provision											79.3
Total											4,225.7

Net insurance liabilities

Accident year	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	Total £m
Estimate of ultimate net claims costs:											
At end of accident year	3,334.7	3,790.6	3,902.0	2,644.4	2,271.8	2,093.9	1,971.0	1,926.7	1,922.2	2,016.9	
One year later	52.0	70.0	(125.2)	(131.5)	(146.7)	(123.6)	(29.7)	(67.0)	(18.9)		
Two years later	15.9	(17.4)	(120.4)	(82.1)	(107.8)	(134.4)	(42.0)	(77.8)			
Three years later	(22.8)	(54.1)	(44.0)	(76.5)	(35.6)	(27.8)	(100.7)				
Four years later	(45.8)	(67.0)	(93.6)	(48.7)	(11.6)	(64.3)					
Five years later	(48.7)	(29.6)	(52.3)	(37.3)	(54.2)						
Six years later	(30.9)	(74.6)	(43.9)	(37.0)							
Seven years later	(24.5)	(38.2)	(24.8)								
Eight years later	(16.2)	(0.4)									
Nine years later	(13.0)										
Current estimate of cumulative claims	3,200.7	3,579.3	3,397.8	2,231.3	1,915.9	1,743.8	1,798.6	1,781.9	1,903.3	2,016.9	
Cumulative payments to date	(3,141.4)	(3,436.3)	(3,288.7)	(2,130.5)	(1,830.9)	(1,593.3)	(1,524.2)	(1,467.7)	(1,441.8)	(1,050.4)	
Net liability recognised in balance sheet	59.3	143.0	109.1	100.8	85.0	150.5	274.4	314.2	461.5	966.5	2,664.3
2007 and prior											400.9
Claims handling provision											79.3
Total											3,144.5

Movements in gross and net insurance liabilities

	Gross £m	Reinsurance £m	Net £m
Claims reported	2,732.2	(375.0)	2,357.2
Incurred but not reported	1,697.9	(546.9)	1,151.0
Claims handling provision	94.4	–	94.4
At 1 January 2016	4,524.5	(921.9)	3,602.6
Cash paid for claims settled in the year	(2,036.9)	18.8	(2,018.1)
Increase / (decrease) in liabilities:			
Arising from current-year claims	2,329.3	(235.4)	2,093.9
Arising from prior-year claims	(150.3)	(139.8)	(290.1)
At 31 December 2016	4,666.6	(1,278.3)	3,388.3
Claims reported	2,584.5	(388.3)	2,196.2
Incurred but not reported	2,002.8	(890.0)	1,112.8
Claims handling provision	79.3	–	79.3
At 31 December 2016	4,666.6	(1,278.3)	3,388.3
Cash paid for claims settled in the year	(2,012.0)	14.0	(1,998.0)
Increase / (decrease) in liabilities:			
Arising from current-year claims	2,389.9	(200.3)	2,189.6
Arising from prior-year claims	(818.8)	383.4	(435.4)
At 31 December 2017	4,225.7	(1,081.2)	3,144.5
Claims reported	3,003.7	(742.5)	2,261.2
Incurred but not reported	1,142.7	(338.7)	804.0
Claims handling provision	79.3	–	79.3
At 31 December 2017	4,225.7	(1,081.2)	3,144.5

Movement in prior-year net claims liabilities by operating segment

	2017 £m	2016 £m
Motor	(275.5)	(123.5)
Home	(23.7)	(75.9)
Rescue and other personal lines	(6.8)	(17.5)
Commercial	(86.3)	(49.8)
Total Ongoing	(392.3)	(266.7)
Run-off	(43.1)	(23.4)
Total	(435.4)	(290.1)

34. Unearned premium reserve

Movement in unearned premium reserve

	Gross £m	Reinsurance £m	Net £m
At 1 January 2016	1,476.6	(89.5)	1,387.1
Net movement in the year	71.3	(4.0)	67.3
At 31 December 2016	1,547.9	(93.5)	1,454.4
Net movement in the year	52.4	(3.8)	48.6
At 31 December 2017	1,600.3	(97.3)	1,503.0

35. Share-based payments

The Group operates equity-settled, share-based compensation plans in the form of an LTIP, a Restricted Shares Plan, a DAIP and Direct Line Group Share Incentive Plans, including both the Free Share awards and a Buy-As-You-Earn Plan, details of which are set out below. All awards are to be satisfied using market purchased shares.

Long-Term Incentive Plan

Executive Directors and certain members of senior management are eligible to participate in the LTIP with awards granted in the form of nil-cost options. Under the plan, the shares vest at the end of a three-year period dependent upon the continued employment by the Group and also the Group achieving predefined performance conditions associated with TSR and RoTE. For awards made after the 2017 AGM, the Directors will be subject to an additional two-year holding period following the three-year vesting period.

Awards were made in the year ended 31 December 2017 over 4.2 million Ordinary Shares with an estimated fair value of £15.2 million at the 2017 grant dates (2016: 3.3 million Ordinary Shares with an estimated fair value of £12.4 million).

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

The table below details the inputs into the model.

	2017	2016
Weighted average assumptions during the year:		
Share price (pence)	359	368
Exercise price (pence)	0	0
Volatility of share price	20%	18%
Average comparator volatility	30%	29%
Expected life	3 years	3 years
Risk-free rate	0.2%	0.3%

Expected volatility was determined by considering the actual volatility of the Group's share price since its IPO and that of a group of listed UK insurance companies.

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

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

Restricted Shares Plan

The purpose of the Restricted Shares Plan is to facilitate the wider participation in Group share-based awards to eligible employees. These awards can be granted at any time during the year, generally have no performance criteria, and vest over periods ranging between one and three years from the date of the grant, subject to continued employment. During the year awards were made over 1.1 million Ordinary Shares (2016: 0.3 million Ordinary Shares) with an estimated fair value of £3.9 million (2016: £0.9 million) using the market value at the date of grant.

Deferred Annual Incentive Plan

To incentivise delivery of performance over a one-year operating cycle, Executive Directors and certain members of senior management are eligible for awards under the AIP, of which at least 40% is granted in the form of a nil-cost option under the DAIP with the remainder being settled in cash following year end. During the year awards were made over 0.9 million Ordinary Shares (2016: 1.0 million Ordinary Shares) under this plan with an estimated fair value of £2.9 million (2016: £3.7 million) using the market value at the date of grant.

The awards outstanding at 31 December 2017 have no performance criteria attached, other than the requirement that the employee remains in employment with the Group for three years from the date of grant.

Direct Line Group Share Incentive Plans: Free Share awards

In 2016, the Group offered all eligible UK employees a Free Share award granting 71 Ordinary Shares free of charge. These awards have no performance criteria attached and vest on the third anniversary of the award grant date, subject to completion of three years, continuing employment. The Group initially granted 0.8 million Ordinary Shares with an estimated fair value of £2.8 million using the market value at the date of grant.

Direct Line Group Share Incentive Plans: Buy-As-You-Earn Plan

The Buy-As-You-Earn Plan entitles employees to purchase shares from pre-tax pay for between £10 and £150 per month and receive one matching share for every two shares purchased.

In the year ended 31 December 2017, matching share awards were granted over 0.4 million Ordinary Shares (2016: 0.4 million Ordinary Shares) with an estimated fair value of £1.3 million (2016: £1.3 million). The fair value of each matching share award is estimated using the market value at the date of grant.

Under the plan, the shares vest at the end of a three-year period dependent upon the continued employment with the Group together with continued ownership of the associated purchased shares up to the point of vesting.

Movement in total share awards

	Number of share awards millions 2017	Number of share awards millions 2016
At 1 January	18.1	17.2
Granted during the year[1]	9.6	7.7
Forfeited during the year	(1.3)	(0.8)
Exercised during the year	(6.2)	(6.0)
At 31 December	20.2	18.1
Exercisable at 31 December	1.9	2.6

Note:
1. In accordance with the rules of the LTIP and DAIP award plans, additional awards of 3.0 million shares were granted during the year ended 31 December 2017 (2016: 1.9 million) in respect of the equivalent dividend.

In respect of the outstanding options at 31 December 2017, the weighted average remaining contractual life is 1.39 years (2016: 1.39 years). No share awards expired during the year (2016: nil).

The weighted average share price for awards exercised during the year ended 31 December 2017 was £3.61 (2016: £3.68).

The Group recognised total expenses in the year ended 31 December 2017 of £14.8 million (2016: £16.8 million) relating to equity-settled share-based compensation plans.

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

36. Trade and other payables, including insurance payables

	2017 £m	2016 £m
Due to agents, brokers and intermediaries	18.2	15.5
Due to reinsurers	74.2	84.1
Due to insurance companies	4.0	4.4
Trade creditors and accruals	282.8	334.7
Other creditors	95.9	98.4
Other taxes	103.9	93.0
Provisions	74.2	64.8
Deferred income	4.8	4.3
Total	658.0	699.2

Movement in provisions during the year

	Regulatory levies £m	Restructuring £m	Other £m	Total £m
At 1 January 2017	28.2	10.1	26.5	64.8
Additional provision	45.6	10.2	36.2	92.0
Utilisation of provision	(42.1)	(11.4)	(19.9)	(73.4)
Released to income statement	–	(2.5)	(6.7)	(9.2)
At 31 December 2017	31.7	6.4	36.1	74.2

37. Notes to the consolidated cash flow statement

	2017 £m	2016 £m
Profit for the year	434.0	278.8
Adjustments for:		
Investment return	(175.4)	(171.5)
Instalment income	(116.4)	(107.1)
Finance costs	103.8	37.2
Defined benefit pension scheme – net interest income	(0.3)	(0.5)
Equity-settled share-based payment charge	14.8	16.8
Tax charge	105.0	74.2
Depreciation and amortisation charges	82.0	87.5
Impairment of property, plant and equipment, goodwill and intangible assets	56.9	39.3
Impairment provision movements on reinsurance contracts	9.2	(3.2)
(Fair value adjustment) / impairment charge on assets held for sale – freehold property	(0.4)	19.7
Loss on sale of property, plant and equipment	0.7	1.7
Operating cash flows before movements in working capital	513.9	272.9
Movements in working capital:		
Net decrease in net insurance liabilities including reinsurance assets, unearned premium reserves and deferred acquisition costs	(186.7)	(143.1)
Net increase in prepayments and accrued income and other assets	(15.2)	(20.1)
Net decrease / (increase) in insurance and other receivables	7.1	(32.5)
Net (decrease) / increase in trade and other payables, including insurance payables	(41.2)	42.7
Contribution to defined benefit pension scheme	–	(2.8)
Cash generated from operations	277.9	117.1
Taxes paid	(76.5)	(83.3)
Cash flow hedges	2.6	1.2
Net cash generated from operating activities before investment of insurance assets	204.0	35.0
Interest received	316.6	294.6
Rental income received from investment property	16.2	18.4
Purchases of investment property	–	(1.4)
Proceeds on disposal of investment property	41.3	25.2
Proceeds on disposal / maturity of AFS debt securities	1,948.4	2,489.9
Net decrease in financial investments: loans and receivables to credit institutions	–	44.9
Advances made for Infrastructure debt and commercial real estate loans	(108.5)	(97.7)
Repayments of infrastructure debt	31.8	11.0
Purchases of AFS debt securities	(1,885.4)	(1,886.5)
Purchases of HTM debt securities	(18.5)	(71.0)
Cash generated from investment of insurance assets	341.9	827.4

The table below details changes in liabilities arising from the Group's financing activities.

	Subordinated liabilities 2017 £m	Interest rate swaps[1] 2017 £m
At 1 January 2017	(539.6)	38.4
Repayment of subordinated liabilities	326.8	–
Interest paid on subordinated liabilities[2]	51.6	–
Interest rate swap cash settlement	–	(19.9)
Financing cash flows	378.4	(19.9)
Premium paid to buy back of debt issued	(76.8)	–
Amortisation of arrangement costs and discount on issue of subordinated liabilities	(2.2)	–
Accrued interest expense on subordinated liabilities	(47.5)	–
Unrealised gain on associated interest rate risk on hedged item	11.7	–
Realised gain on associated interest rate risk on hedged item	11.3	10.7
Net accrued interest on interest rate swap	–	(1.2)
Fair value movement in interest rate swap	–	(11.7)
Non-cash changes	(103.5)	(2.2)
At 31 December 2017	(264.7)	16.3

Notes:

1. The interest rate swaps relate to Group's 10- year designated hedging instrument to exchange the fixed rate of interest for a floating rate of three-month LIBOR plus a spread of 706 basis points which was credit value adjusted to 707 basis points with effect from 29 July 2013.
2. This includes £2.7 million of accrued interest settled in relation to the £250 million of repayment of subordinated guaranteed notes.

38. Contingent liabilities

The Group did not have any material contingent liabilities at 31 December 2017 (2016: none).

39. Commitments

Operating lease commitments where the Group is the lessee

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

	2017 £m	2016 £m
Lease payments under operating leases recognised as an expense in the year	18.8	18.3

The following table analyses the outstanding commitments for future minimum lease payments under non-cancellable operating leases by the period in which they fall due.

	2017 £m	2016 £m
Within one year	19.2	17.4
In the second to fifth years inclusive	58.1	54.2
After five years	154.8	159.7
Total	232.1	231.3

Operating lease commitments where the Group is the lessor

The following table analyses future aggregate minimum lease payments receivable under non-cancellable operating leases in respect of property leased to third-party tenants.

	2017 £m	2016 £m
Within one year	15.3	16.3
In the second to fifth years inclusive	46.1	53.0
After five years	73.1	78.9
Total	134.5	148.2

40. Fair value

Fair value hierarchy

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

- level 1 financial assets are measured in whole or in part by reference to published quotes in an active market. In an active market quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.
- level 2 financial assets and liabilities are measured using a valuation technique based on assumptions that are supported by prices from observable current market transactions. These are assets for which pricing is obtained via pricing services, but where prices have not been determined in an active market, or financial assets with fair values based on broker quotes or assets that are valued using the Group's own models whereby the majority of assumptions are market-observable.
- level 3 fair value measurements used for investment properties, HTM debt securities, infrastructure debt and commercial real estate loans are those derived from a valuation technique that includes inputs for the asset that are unobservable.

Comparison of carrying value to fair value of financial instruments and assets carried at fair value

The following table compares the carrying value and the fair value of financial instruments and other assets where the Group discloses a fair value.

At 31 December 2017	Carrying value £m	Level 1 £m	Level 2 £m	Level 3 £m	Fair value £m
Assets held at fair value:					
Investment property (note 19)	**309.3**	–	–	309.3	**309.3**
Derivative assets (note 24)	**84.4**	–	84.4	–	**84.4**
AFS debt securities (note 26)	**4,451.4**	224.8	4,226.6	–	**4,451.4**
Other financial assets:					
HTM debt securities (note 26)	**103.6**	–	14.4	92.8	**107.2**
Infrastructure debt (note 26)	**316.4**	–	–	326.0	**326.0**
Commercial real estate loans (note 26)	**169.0**	–	–	169.0	**169.0**
Total assets	**5,434.1**	**224.8**	**4,325.4**	**897.1**	**5,447.3**
Liabilities held at fair value:					
Derivative liabilities (note 24)	**12.0**	–	12.0	–	**12.0**
Other financial liabilities:					
Subordinated liabilities (note 32)	**264.7**	–	328.7	–	**328.7**
Total liabilities	**276.7**	**–**	**340.7**	**–**	**340.7**

At 31 December 2016	Carrying value £m	Level 1 £m	Level 2 £m	Level 3 £m	Fair value £m
Assets held at fair value:					
Investment property (note 19)	329.0	–	–	329.0	329.0
Derivative assets (note 24)	79.7	–	79.7	–	79.7
AFS debt securities (note 26)	4,645.2	341.2	4,304.0	–	4,645.2
Other financial assets:					
HTM debt securities (note 26)	85.1	–	13.6	74.6	88.2
Infrastructure debt (note 26)	337.0	–	–	339.2	339.2
Commercial real estate loans (note 26)	79.7	–	–	79.8	79.8
Total assets	5,555.7	341.2	4,397.3	822.6	5,561.1
Liabilities held at fair value:					
Derivative liabilities (note 24)	45.1	–	45.1	–	45.1
Other financial liabilities:					
Subordinated liabilities (note 32)	539.6	–	625.0	–	625.0
Total liabilities	584.7	–	670.1	–	670.1

Differences arise between carrying value and fair value where the measurement basis of the asset or liability is not fair value (e.g. assets and liabilities carried at amortised cost). Fair values of the following assets and liabilities approximate their carrying values:

- insurance and other receivables;
- cash and cash equivalents;
- borrowings; and
- trade and other payables, including insurance payables (excluding provisions).

The movements in assets held at fair value and classified as level 3 in the fair value hierarchy are within investment property, HTM debt securities, commercial real estate loans and infrastructure debt. There were no changes in the categorisation of assets between levels 1, 2 and 3 for assets and liabilities held by the Group since 31 December 2016.

41. Related parties

Transactions between the Group's subsidiary undertakings, which are related parties, have been eliminated on consolidation and accordingly are not disclosed.

There were no sales and purchases of products and services to or from related parties in the year ended 31 December 2017 (2016: £nil).

Year end balances arising from sales of products and services to related parties

	2017 £m	2016 £m
Total[1]	–	0.2

Note:

1. This balance relates to an amount recoverable from RBS Group plc, the Group's former parent company and originates from a period when they were still a related party.

Movement in amounts owed by related parties

	2017 £m	2016 £m
At 1 January	0.2	0.2
Settled in the year	(0.2)	–
At 31 December	–	0.2

Compensation of key management

	2017 £m	2016 £m
Short-term employee benefits	10.6	8.4
Termination benefits	–	0.1
Share-based payments	5.5	7.6
Total	16.1	16.1

Parent Company balance sheet

As at 31 December 2017

	Notes	2017 £m	2016 £m
Assets			
Investment in subsidiary undertakings	2	3,099.1	3,084.3
Other receivables	3	613.5	571.4
Current tax assets	4	16.1	0.8
Derivative financial instruments	5	1.0	1.7
Financial investments	6	5.2	134.8
Cash and cash equivalents	7	209.3	157.5
Total assets		3,944.2	3,950.5
Equity			
Shareholders' equity		3,257.5	3,437.5
Tier 1 notes	9	346.5	–
Total equity		3,604.0	3,437.5
Liabilities			
Subordinated liabilities	10	252.7	504.5
Borrowings	11	84.5	–
Derivative financial instruments	5	1.0	1.7
Trade and other payables	12	1.4	6.4
Deferred tax liabilities	4	0.6	0.4
Total liabilities		340.2	513.0
Total equity and liabilities		3,944.2	3,950.5

The attached notes on pages 167 to 171 form an integral part of these separate financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 26 February 2018. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Direct Line Insurance Group plc

Registration No. 02280426

Parent Company statement of comprehensive income

For the year ended 31 December 2017

	2017 £m	2016 £m
Profit for the year	50.6	764.9
Other comprehensive (loss) / income		
Items that may be reclassified subsequently to income statement:		
Fair value (loss) / gain on AFS investments	(0.4)	0.5
Tax relating to items that may be reclassified	0.1	(0.1)
Other comprehensive (loss) / income for the year net of tax	(0.3)	0.4
Total comprehensive income for the year attributable to owners of the Company	50.3	765.3

Parent Company statement of changes in equity

For the year ended 31 December 2017

	Share capital £m	Capital reserves £m	Share-based payment reserve £m	AFS revaluation reserve £m	Retained earnings £m	Shareholders' equity £m	Tier 1 notes £m	Total equity £m
Balance at 1 January 2016	150.0	1,450.0	10.6	–	1,521.0	3,131.6	–	3,131.6
Total comprehensive income for the year	–	–	–	0.4	764.9	765.3	–	765.3
Dividends paid	–	–	–	–	(450.6)	(450.6)	–	(450.6)
Credit to equity for equity-settled share-based payments	–	–	16.8	–	–	16.8	–	16.8
Shares distributed by employee trusts	–	–	(25.6)	–	–	(25.6)	–	(25.6)
Balance at 31 December 2016	150.0	1,450.0	1.8	0.4	1,835.3	3,437.5	–	3,437.5
Total comprehensive income for the year	–	–	–	(0.3)	50.6	50.3	–	50.3
Dividends paid (note 13)	–	–	–	–	(225.3)	(225.3)	–	(225.3)
Credit to equity for equity-settled share-based payments	–	–	14.8	–	–	14.8	–	14.8
Shares distributed by employee trusts	–	–	(19.8)	–	–	(19.8)	–	(19.8)
Issue of Tier 1 notes (note 9)	–	–	–	–	–	–	346.5	346.5
Balance at 31 December 2017	150.0	1,450.0	(3.2)	0.1	1,660.6	3,257.5	346.5	3,604.0

The attached notes on pages 167 to 171 form an integral part of these separate financial statements.

Parent Company cash flow statement

For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Net cash used in operating activities	14	(7.9)	(5.1)
Cash flows from investing activities			
Interest received on loans to subsidiary undertakings		47.5	47.6
Interest received on AFS debt securities		10.5	4.7
Dividends received from subsidiary undertakings		114.0	780.6
Net increase in loans advanced to subsidiary undertakings		(59.4)	(28.8)
Capital contribution to subsidiary undertakings		–	(16.9)
Proceeds on disposal / maturity of AFS debt securities		119.8	5.0
Purchase of AFS debt securities		–	(136.9)
Net cash generated from investing activities		232.4	655.3
Cash flows from financing activities			
Net proceeds from issue of Tier 1 notes		346.5	–
Dividends paid	13	(225.3)	(450.6)
Purchase of employee trust shares		–	(25.6)
Repayment of subordinated liabilities		(326.8)	–
Proceeds of borrowings from related parties		150.3	–
Repayments of borrowings from related parties		(65.9)	–
Finance costs		(51.5)	(46.3)
Net cash used in financing activities		(172.7)	(522.5)
Net increase in cash and cash equivalents		51.8	127.7
Cash and cash equivalents at the beginning of the year	7	157.5	29.8
Cash and cash equivalents at the end of the year	7	209.3	157.5

The attached notes on pages 167 to 171 form an integral part of these separate financial statements.

Notes to the Parent Company financial statements

1. Accounting policies

1.1 Basis of preparation

Direct Line Insurance Group plc, registered in England and Wales (company number 02280426), is the ultimate Parent Company of the Group. The principal activity of the Company is managing its investments in subsidiaries, providing loans to those subsidiaries, raising funds for the Group and the receipt and payment of dividends.

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

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

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

1.2 Investment in subsidiaries

Investment in subsidiaries is stated at cost less any impairment.

1.3 Dividend income

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

2. Investment in subsidiary undertakings

	2017 £m	2016 £m
At 1 January	3,084.3	3,067.4
Additional investment in subsidiary undertakings	14.8	16.9
At 31 December	3,099.1	3,084.3

The subsidiary undertakings of the Company are set out below. Their capital consists of Ordinary Shares which are unlisted. In all cases, the Company owns 100% of the Ordinary Shares, either directly or through its ownership of other subsidiaries, and exercises full control over their decision making.

Name of subsidiary	Place of incorporation and operation	Principal activity
Directly held by the Company:		
Direct Line Group Limited[1]	United Kingdom	Intermediate holding company
DL Insurance Services Limited[1]	United Kingdom	Management services
Finsure Premium Finance Limited[1]	United Kingdom	Non-trading company
Inter Group Insurance Services Limited[1]	United Kingdom	Non-trading company
UK Assistance Accident Repair Centres Limited[1]	United Kingdom	Motor vehicle repair services
UK Assistance Limited[1]	United Kingdom	Dormant
U K Insurance Business Solutions Limited[1]	United Kingdom	Insurance broking services
U K Insurance Limited[2,3]	United Kingdom	General insurance

2. Investment in subsidiary undertakings continued

Name of subsidiary	Place of incorporation and operation	Principal activity
Indirectly held by the Company:		
10-15 Livery Street, Birmingham UK Limited[4]	Jersey	Non-trading company
Churchill Insurance Company Limited[1]	United Kingdom	General insurance
Direct Line Insurance Limited[1]	United Kingdom	Dormant
DL Support Services India Private Limited[5]	India	Support and operational services
DLG Legal Services Limited[6]	United Kingdom	Legal services
DLG Pension Trustee Limited[1]	United Kingdom	Dormant
Farmweb Limited[1]	United Kingdom	Non-trading company
Green Flag Group Limited[2]	United Kingdom	Intermediate holding company
Green Flag Holdings Limited[1]	United Kingdom	Intermediate holding company
Green Flag Limited[2]	United Kingdom	Breakdown recovery services
Intergroup Assistance Services Limited[1]	United Kingdom	Non-trading company
National Breakdown Recovery Club Limited[1]	United Kingdom	Dormant
Nationwide Breakdown Recovery Services Limited[1]	United Kingdom	Dormant
The National Insurance and Guarantee Corporation Limited[1]	United Kingdom	Dormant
UKI Life Assurance Services Limited[1]	United Kingdom	Dormant

Notes:
1. Registered office at: Churchill Court, Westmoreland Road, Bromley, BR1 1DP.
2. Registered office at: The Wharf, Neville Street, Leeds, LS1 4AZ.
3. U K Insurance Limited has a branch, as defined in section 1046 (3) of the Companies Act 2006 in the Republic of South Africa.
4. Registered office at: 22 Grenville Street, St Helier, JE4 8PX, Jersey.
5. Registered office at: 4 Aradhana Enclave, Sector 13, Rama Krishna Puram, New Delhi, South West Delhi, Delhi, 110066, India.
6. Registered office at: 42 The Headrow, Leeds, LS1 8HZ.

3. Other receivables

	2017 £m	2016 £m
Loans to subsidiary undertakings[1]	612.2	569.6
Other debtors	1.3	1.8
Total	**613.5**	571.4
Current	113.5	71.4
Non-current	500.0	500.0
Total	**613.5**	571.4

Note:
1. Included in loans to subsidiary undertakings is a £500 million unsecured subordinated loan to U K Insurance Limited. The loan was advanced on 27 April 2012 at a fixed rate of 9.5% with a repayment date of 27 April 2042. There is an option to repay the loan on specific dates from 27 April 2022. If the loan is not repaid on 27 April 2022, the rate of interest will be reset at a rate of the six-month LIBOR plus 8.16%. All loans are neither past due nor impaired.

4. Current and deferred tax

	2017 £m	2016 £m
Per balance sheet:		
Current tax assets	16.1	0.8
Deferred tax liabilities	(0.6)	(0.4)

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

	Provisions and other temporary differences £m	AFS revaluation reserve £m	Total £m
At 1 January 2016	–	–	–
Charge to the income statement	(0.3)	–	(0.3)
Charge to other comprehensive income	–	(0.1)	(0.1)
At 31 December 2016	(0.3)	(0.1)	(0.4)
Credit to the income statement	0.4	–	0.4
Credit to other comprehensive income	–	0.1	0.1
Other movements	(0.7)	–	(0.7)
At 31 December 2017	(0.6)	–	(0.6)

5. Derivative financial instruments

	Notional amount	Fair value	Notional amount	Fair value
	2017 £m	2017 £m	2016 £m	2016 £m
Derivative assets				
Designated as hedging instruments:				
Foreign exchange contracts[2]	17.3	1.0	14.8	1.7
Total	17.3	1.0	14.8	1.7
Derivative liabilities				
Designated as hedging instruments:				
Foreign exchange contracts[2]	17.3	1.0	14.8	1.7
Total	17.3	1.0	14.8	1.7

Notes:

1. The derivative assets and liabilities are both classified as level 2 within the Group's fair value hierarchy set out in note 40 of the consolidated financial statements.
2. The foreign exchange cash flow hedges have been entered into on behalf of Group subsidiary companies.

6. Financial investments

	2017 £m	2016 £m
AFS debt securities[1]	5.2	134.8

Note:

1. The AFS debt securities are fixed interest UK Sovereign debt classified as level 1 within the Group's fair value hierarchy which is set out in note 40 of the consolidated financial statements.

7. Cash and cash equivalents

	2017 £m	2016 £m
Cash at bank and in hand	3.8	0.2
Short-term deposits with credit institutions[1]	205.5	157.3
Total	209.3	157.5

Note:

1. This represents money market funds with no notice period for withdrawal.

8. Share capital and capital reserves

Full details of the share capital and capital reserves of the Company are set out in notes 29 and 30 to the consolidated financial statements.

9. Tier 1 notes

Full details of the Tier 1 notes of the Company are set out in note 31 to the consolidated financial statements.

10. Subordinated liabilities

	2017 £m	2016 £m
Subordinated guaranteed dated notes	252.7	504.5

The subordinated guaranteed dated notes with a nominal value of £500 million were issued on 27 April 2012 at a fixed rate of 9.25% and have a redemption date of 27 April 2042. The Company has the option to repay the notes on specific dates from 27 April 2022. If the notes are not repaid on 27 April 2022, the rate of interest will be reset at a rate of the six-month LIBOR plus 7.91%.

On 8 December 2017, the Company repurchased £250 million nominal value of subordinated guaranteed dated notes for a purchase price of £330.1 million including accrued interest of £2.7 million and associated transaction costs of £0.6 million.

The Company has the option, in certain circumstances, to defer interest payments on the notes but to date has not exercised this right.

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

The notes are guaranteed by U K Insurance Limited, a principal subsidiary of the Company.

The aggregate fair value of subordinated guaranteed dated notes at 31 December 2017 was £328.7 million (2016: £625.0 million).

11. Borrowings

	2017 £m	2016 £m
Loans from fellow subsidiaries within the Group[1]	84.5	–

Note:

1. Included in the above is a loan of £61.5 million (2016: £nil) from UK Assistance Accident Repair Centres Limited. Other loans of £23.0 million from fellow Group subsidiaries are repayable on demand and are subject to interest on outstanding balances based on the average 3 month LIBOR rate.

12. Trade and other payables

	2017 £m	2016 £m
Payables to subsidiary undertakings	0.1	4.7
Payables to third parties	1.3	1.7
Total	1.4	6.4

13. Dividends

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

14. Cash used by operations

	2017 £m	2016 £m
Profit for the year	50.6	764.9
Adjustments for:		
Investment return	(182.5)	(829.4)
Finance costs	124.6	46.9
Impairment of loans to share trusts	16.8	16.8
Tax credit	(15.9)	(0.5)
Operating cash flows before movements in working capital	(6.4)	(1.3)
Movements in working capital:		
Net decrease / (increase) in other debtors	0.5	(1.8)
Net decrease in trade and other payables	(5.0)	(0.2)
Taxes received / (paid)	0.8	(3.0)
Cash flow hedges	2.2	1.2
Net cash used in operating activities	(7.9)	(5.1)

The table below details the changes in liabilities arising from financing activities.

	Subordinated liabilities 2017 £m
At 1 January 2017	(504.5)
Repayment of subordinated liabilities	326.8
Interest paid on subordinated liabilities[1]	51.5
Financing cash flows	378.3
Premium paid to buy back of debt issued	(76.8)
Amortisation of arrangement costs and discount on issue of subordinated liabilities	(2.2)
Accrued interest expense on subordinated liabilities	(47.5)
Non-cash changes	(126.5)
At 31 December 2017	(252.7)

Note:

1. This includes £2.7 million of accrued interest settled in relation to the £250 million of repayment of subordinated guaranteed notes.

15. Related parties

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

The following transactions were carried out with related parties:

Sales of services

	2017 £m	2016 £m
Interest receivable from subsidiary undertakings	48.0	47.9
Dividend income from subsidiary undertakings	133.8	780.6

Interest income from loans to subsidiary undertakings was charged at rates ranging from 0.3% to 9.5% (2016: 0.4% to 9.5%).

Purchases of services

	2017 £m	2016 £m
Management fees payable to subsidiary undertakings	23.6	18.1
Interest payable to subsidiary undertakings	0.1	–

Interest charged on borrowings from related parties in the year ended 31 December 2017 was at rates ranging from 0.3% to 0.5% (2016: £nil).

16. Share-based payments

Full details of share-based compensation plans are provided in note 35 to the consolidated financial statements.

17. Risk management

The risks faced by the Company, arising from its investment in subsidiaries, are considered to be the same as those in the operations of the Group. Details of the key risks and the steps taken to manage them are disclosed in note 3 to the consolidated financial statements. The Company also holds, on behalf of its subsidiaries, designated hedging instruments which relate to foreign currency supplier payments.

18. Directors and key management remuneration

The Directors and key management of the Group and the Company are the same. The aggregate emoluments of the Directors are set out in note 10 to the consolidated financial statements, the compensation for key management is set out in note 41 to the consolidated financial statements and the remuneration and pension benefits payable in respect of the highest paid Director are included in the Directors' remuneration report in the Governance section of the Annual Report & Accounts.

Corporate website

The Group's corporate website is www.directlinegroup.com. It contains useful information for the Company's investors and shareholders. For example, it includes press releases, details of forthcoming events, essential shareholder information, a dividend history, a financial calendar, and details of the Company's AGM. You can also subscribe to email news alerts.

Market

The Company has a premium listing on the UK Listing Authority's Official List. The Company's Ordinary Shares (EPIC: DLG) are admitted to trading on the London Stock Exchange.

Share ownership

Share capital

You can find details of the Company's share capital in note 29 to the consolidated financial statements.

Dividends

The Company pays its dividends in Sterling to shareholders registered on its register of members at the relevant record date.

Shareholders can arrange to receive their cash dividend payments in a bank or building society account by completing a dividend mandate form. This is available from the Company's registrar, Computershare Investor Services PLC ("**Registrar**"), in the UK. You can find the Registrar's contact details on page 181. Alternatively, shareholders can access their shareholdings online and download a dividend mandate form from the Investor Centre. You can find details of this below.

Dividend Reinvestment Plan

The Company offers a Dividend Reinvestment Plan. This enables shareholders to use their cash dividends to buy the Company's Ordinary Shares in the market. You can find more details on the Company's website.

Shareholder enquiries

Shareholders with queries about anything relating to their shares can contact our Registrar.

Shareholders should notify the Registrar of any change in shareholding details, such as their address, as soon as possible.

Shareholders can access their current shareholding details online at www.investorcentre.co.uk/directline. Investor Centre is a free-to-use, secure, self-service website that enables shareholders to manage their holdings online. The website allows shareholders to:

- check their holdings;
- update their records, including address and direct credit details;
- access all their securities in one portfolio by setting up a personal account;
- vote online; and
- register to receive electronic shareholder communications.

To access information, the website requires shareholders to quote their Shareholder Reference Number. Shareholders can find this number on their share certificates.

Shareholder warning

Almost five thousand people contact the FCA about share fraud each year – and victims lose an average of £20,000.

Fraudsters use persuasive and high-pressure tactics to lure investors into scams. They may offer to sell shares that prove to be worthless or non-existent. Or they can offer to buy shares at an inflated price in return for you paying upfront. They promise high profits. However, if you buy or sell shares in this way, you will probably lose your money.

How to avoid share fraud

- Remember that FCA-authorised firms are unlikely to contact you unexpectedly offering to buy or sell shares
- Do not converse with them. Note the name of the person and firm contacting you, then end the call
- To see if the person and firm contacting you are authorised by the FCA, check the Financial Services Register at www.fca.org.uk
- Beware of fraudsters claiming to be from an authorised firm; copying its website; or giving you false contact details
- If you want to phone the caller back, use the firm's contact details listed on the Financial Services Register at www.fca.org.uk
- If the firm does not have contact details on the Register or they tell you the details are out of date, call the FCA on 0800 111 6768
- Search the list of unauthorised firms to avoid at www.fca.org.uk/consumers/scams
- Remember that if you buy or sell shares from an unauthorised firm, you cannot access the Financial Ombudsman Service or Financial Services Compensation Scheme
- Get independent financial and professional advice before handing over any money
- If it sounds too good to be true, it probably is

Report a scam

If fraudsters approach you, tell the FCA using the share fraud reporting form at www.fca.org.uk/consumers/scams. You can also find out more about investment scams on the same web page.

You can call the FCA Consumer Helpline on 0800 111 6768.

If you have already paid money to share fraudsters, call Action Fraud on 0300 123 2040.

Tips on protecting your shares

- Keep all your certificates in a safe place. Alternatively, consider holding your shares in the UK's electronic registration and settlement system for equity, called CREST, or via a nominee
- Keep correspondence from the Registrar that shows your shareholder reference number in a safe place, and shred unwanted correspondence
- Inform the Registrar as soon as you change your address
- If you receive a letter from the Registrar regarding a change of address and you have not recently moved, contact them immediately
- Find out when your dividends are paid and contact the Registrar if you do not receive them
- Consider having your dividends paid direct into your bank account. You will need to complete a dividend mandate form and send it to the Registrar. This reduces the risk of cheques being stolen or lost in the post
- If you change your bank account, inform the Registrar of your new account details immediately
- If you are buying or selling shares, only deal with brokers registered in the UK or in your country of residence
- Be aware that the Company will never call you concerning investments. If you receive such a call from a person saying they represent the Group, please contact the Company Secretary immediately, by calling +44 (0)1132 920 667

Electronic communications and voting

The Group produces various communications. Shareholders can view these online, download them, or receive paper copies by contacting the Registrar.

Shareholders, who register their email address with our Registrar, or at the Investor Centre, can receive emails with news on events, such as the AGM. They can also receive shareholder communications electronically, such as the Annual Report & Accounts and Notice of Meeting.

Dealing facilities

Shareholders who wish to buy, sell or transfer their shares may do so through a stockbroker or a high street bank; or through the Registrar's share-dealing facility.

You can call or email the Registrar regarding its share-dealing facility using this contact information:

- For telephone sales, call +44 (0)370 703 0084 between 8.00 am and 4.30 pm, Monday to Friday, excluding public holidays
- For internet sales, go to www.investorcentre.co.uk/directline. You will need your Shareholder Reference Number, as shown on your share certificate, or your welcome letter from the Chairman.

Dividend tax allowance

From April 2016, dividend tax credits were replaced by an annual £5,000 tax-free allowance across an individual's entire share portfolio. Above this amount, individuals will pay tax on their dividend income. The rate of this tax depends on their income tax bracket and personal circumstances. The Company will continue providing registered shareholders with a confirmation of the dividends paid. Shareholders should include this with any other dividend income they receive when calculating and reporting total dividend income received to HMRC. The shareholder is responsible for including all dividend income when calculating tax requirements. If you have any tax queries, please contact your financial adviser.

Financial calendar

2018

Date	Event
27 February	Preliminary Results 2017
05 April	'Ex-dividend' date for 2017 final dividend
06 April	Record date for 2017 final dividend
02 May[1]	Trading update for the first quarter of 2018
10 May	Annual General Meeting
17 May	Payment date for 2017 final dividend
01 August[1]	Half Year Report 2018
09 August[1]	'Ex-dividend' date for 2018 interim dividend
10 August[1]	Record date for 2018 interim dividend
07 September[1]	Payment date for 2018 interim dividend
06 November[1]	Trading update for the third quarter of 2018

Annual General Meeting

The 2018 AGM will be held on 10 May 2018 at the offices of Allen & Overy LLP, One Bishops Square, London E1 6AD, starting at 11.00 am. All shareholders will receive a separate notice convening the AGM. This will explain the resolutions to be put to the meeting.

Note:
1. These dates are subject to change.

Glossary and appendices

Term	Definition and explanation
Actuarial best estimate ("**ABE**")	The probability-weighted average of all future claims and cost scenarios. It is calculated using historical data, actuarial methods and judgement. A best estimate of reserves will therefore normally include no margin for optimism or, conversely, caution.
Adjusted diluted earnings per share	Adjusted diluted earnings per share is calculated by dividing the adjusted profit after tax of Ongoing operations by the weighted average number of Ordinary Shares during the period adjusted for dilutive potential Ordinary Shares. (See Appendix A – APM from page 177).
Adjusted profit after tax	Profit after tax is adjusted to exclude the Run-off segment and restructuring costs, and is stated after charging tax using the UK standard tax rate of 19.25%; (2016: 20.00%). (See Appendix A – APM from page 177).
Annual Incentive Plan ("**AIP**")	This incentivises the performance of executives and employees over a one-year operating cycle. It focuses on the short to medium-term elements of the Group's strategic aims.
Available-for-sale ("**AFS**") investment	Financial assets that are classified as available-for-sale. Please refer to the accounting policy note 1.12 on page 120.
Average written premium	Average written premium is the total written premium at inception divided by the number of policies.
Buy-As-You-Earn Plan	The HM Revenue & Customs approved Buy-As-You-Earn Share Incentive Plan gives all employees the opportunity to become shareholders in the Company.
Capital	The funds invested in the Group, including funds invested by shareholders and retained profits.
Claims frequency	The number of claims divided by the number of policies per year.
Claims handling provision (provision for losses and loss-adjustment expense)	Funds the Group sets aside to meet the estimated cost of settling claims and related expenses that the Group considers it will ultimately need to pay.
Clawback	The ability of the Company to claim repayment of paid amounts for equity settled share-based payments.
Combined operating ratio ("**COR**")	The sum of the loss, commission and expense ratios. The ratio measures the amount of claims costs, commission and expenses, compared to net earned premium generated. A ratio of less than 100% indicates profitable underwriting. Normalised COR adjusts loss and commission ratios for a normal level of major weather events in the period.
Commission expenses	Payments to brokers, partners and PCWs for generating business.
Commission ratio	The ratio of commission expense divided by net earned premium.
Current-year attritional loss ratio	The loss ratio for the current accident year, excluding the movement of claims reserves relating to previous accident years, and claims relating to major weather events in the Home segment.
Deferred Annual Incentive Plan ("**DAIP**")	For Executive Directors, at least 40% of the AIP award is deferred into shares typically vesting three years after grant. The remainder of the award is paid in cash following year-end.
Direct own brands	Direct own brands include Home and Motor under the Direct Line, Churchill and Privilege brands, Rescue under the Green Flag brand and Commercial under the Direct Line for Business brand.
Earnings per share	The amount of the Group's profit allocated to each Ordinary Share of the Company.
Employee Representative Body	A forum that represents all employees, including when there is a legal requirement to consult employees.
Expense ratio	The ratio of operating expenses divided by net earned premium.
Finance costs	The cost of servicing the Group's external borrowings.
Financial Conduct Authority ("**FCA**")	The independent body that regulates firms and financial advisers. It puts the customers' interests and market integrity at the core of financial service providers' activities.
Financial Reporting Council	The UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.
Gross written premium	The total premiums from contracts that began during the period.
International Accounting Standards Board ("**IASB**")	A not-for-profit public interest organisation that is overseen by a monitoring board of public authorities. It develops IFRS: standards that aim to make worldwide markets transparent, accountable and efficient.
Incurred but not reported ("**IBNR**")	Funds set aside to meet the cost of claims for accidents that have occurred, but have not yet been reported to the Group. This includes an element of uplift on the value of claims reported. Where the Group has determined that the value currently held in reserves is not sufficient to meet the estimated ultimate costs if the claim is referred to as incurred but not enough reported ("**IBNER**").
In-force policies	The number of policies on a given date that are active and against which the Group will pay, following a valid insurance claim.

Term	Definition and explanation
Insurance liabilities	This comprises insurance claims reserves and claims handling provision, which the Group maintains to meet current and future claims.
Investment income yield	The income earned from the investment portfolio, recognised through the income statement during the period divided by the average assets under management ("**AUM**"). This excludes unrealised and realised gains and losses, impairments, and fair value adjustments. The average AUM derives from the period's opening and closing balances for the total Group. (See Appendix A – APM from page 177).
Investment return	The return earned from the investment portfolio, including unrealised and realised gains and losses, impairments, and fair value adjustments.
Investment return yield	The return earned from the investment portfolio, recognised through the income statement during the period divided by the average AUM. This includes unrealised and realised gains and losses, impairments, and fair value adjustments. The average AUM derives from the period's opening and closing balances. (See Appendix A – APM from page 177).
Leverage	Tier 1 notes and financial debt (subordinated guaranteed dated notes) as a percentage of total capital employed.
Loss ratio	Net insurance claims divided by net earned premium.
Long-Term Incentive Plan ("**LTIP**")	Awards made as nil-cost options or conditional share awards, which vest to the extent that performance conditions are satisfied after a period of at least three years.
Malus	An arrangement that permits unvested remuneration awards to be forfeited, when the Company considers it appropriate.
Management's best estimate ("**MBE**")	These reserves are based on Management's best estimate, which includes a prudence margin that exceeds the internal ABE.
Net asset value	The net asset value of the Group is calculated by subtracting total liabilities from total assets.
Net claims	The cost of claims incurred in the period less any claims costs recovered under reinsurance contracts. It includes claims payments and movements in claims reserves.
Net earned premium	The element of gross earned premium less reinsurance premium ceded for the period where insurance cover has already been provided.
Net investment income yield	The net investment income yield is calculated in the same way as investment income yield but includes the cost of hedging. (See Appendix A - APM from page 177).
Ogden discount rate	The discount rate set by the Lord Chancellor and used by courts to calculate lump sum awards in bodily injury cases.
Ongoing operations	Ongoing operations comprise Direct Line Group's Ongoing divisions: Motor, Home, Rescue and other personal lines, and Commercial. It excludes run-off and restructuring costs.
Operating profit	The pre-tax profit that the Group's activities generate, including insurance and investment activity, but excluding finance costs.
Own Risk and Solvency Assessment ("**ORSA**")	A Solvency II requirement. It documents the Group's insurance underwriting entities' risks and associated capital requirements, both now and projected over the business planning period. It is forward looking, reflecting business strategy and risk appetite.
Periodic payment order ("**PPO**")	These are claims payments as awarded under the Courts Act 2003. PPOs are used to settle large personal injury claims. They generally provide a lump-sum award plus inflation-linked annual payments to claimants who require long-term care.
Prudential Regulation Authority ("**PRA**")	The PRA is a part of the Bank of England. It is responsible for regulating and supervising insurers and financial institutions in the UK.
Reinsurance	Contractual arrangements where the Group transfers part or all of the accepted insurance risk to another insurer.
Reserves	Funds that have been set aside to meet outstanding insurance claims and IBNR.
Restructuring costs	Restructuring costs are costs incurred in respect of the business activities where the Group has a constructive obligation to restructure its activities.
Return on equity	Return on equity is calculated by dividing the profit attributable to the owners of the Company by average Shareholders' equity for the period.
Return on Tangible Equity ("**RoTE**")	Return on Tangible Equity for 2017 is adjusted profit after tax from Ongoing operations excluding one-off costs in relation to the buy-back of subordinated liabilities, divided by the Group's average shareholders' equity, less goodwill and other intangible assets. Profit after tax is adjusted to exclude the Run-off segment and restructuring costs. It is stated after charging tax using the UK standard tax rate of 19.25% (2016: 20.0%). RoTE for comparative periods is adjusted profit after tax from Ongoing operations, divided by the Group's average shareholders' equity, less goodwill and other intangible assets. Profit after tax is adjusted to exclude run-off and restructuring costs and other one-off costs. (See Appendix A – APM from page 177).

Term	Definition and explanation
Run-off	Where the Group no longer underwrites new business, but continues to meet its claims liabilities under existing contracts.
Solvency II	The capital adequacy regime for the European insurance industry, which became effective on 1 January 2016. It establishes revised capital requirements and risk management standards. It comprises three pillars: Pillar I, which sets out capital requirements for an insurer; Pillar II, which focuses on systems of governance; and Pillar III, which deals with disclosure requirements.
Solvency capital ratio	The ratio of Solvency II own funds to the solvency capital requirement.
Total costs	Total costs comprise operating expenses and claims handling expenses for Ongoing operations.
Total Shareholder Return ("**TSR**")	Compares share price movement with reinvested dividends as a percentage of the share price at the beginning of the period.
Underwriting result profit / (loss)	The profit or loss from operational activities, excluding investment return and other operating income. It is calculated as net earned premium less net insurance claims and total expenses.

Appendix A – Alternative performance measures

The Group has identified Alternative Performance Measures ("**APMs**") in accordance with the European Securities and Markets Authority's published Guidelines. The Group uses APMs to improve comparability of information between reporting periods and reporting segments, by adjusting for either uncontrollable or one-off costs which impact on IFRS measures, to aid the user of the Annual Report in understanding the activity taking place across the Group. These APMs are contained within the main narrative sections of this document, outside of the financial statements and notes, and may not necessarily have standardised meanings for ease of comparability across peer organisations.

Further information is presented below, defined in the glossary on pages from 174 to 176 and reconciled to the most directly reconcilable line items in the financial statements and notes. Note 4 on page 139 of the consolidated financial statements presents a reconciliation of the Group's business activities on a segmental basis to the consolidated income statement including Ongoing operations of the Group. All note references in the table below are to the notes to the consolidated financial statements on pages 112 to 171.

Group APM	Closest equivalent IFRS measure	Definition and / or reconciliation	Rationale for APM
Adjusted diluted earnings per share	Diluted earnings per share	Adjusted diluted earnings per share is defined in the glossary on page 174 and is reconciled on page 178.	This is a representation of the underlying earnings over the number of shares in issue adjusted for potential dilutions from the exercise of options and contingently issuable shares.
Current-year attritional loss ratio	Loss ratio	Current-year attritional loss ratio is defined in the glossary on page 174 and is reconciled to loss ratio (discussed below) on page 36.	Express claims performance in the current accident year in relation to net earned premium.
COR	Operating profit	COR is defined in the glossary on page 174. The constituent parts are underwriting profit defined in the glossary on page 176 and net earned premium (note 5).	This is a measure of underwriting profitability whereby a ratio of less than 100% represents an underwriting profit and a ratio of more than 100% represents an underwriting loss and excludes non-insurance income.
Investment income yield	Investment income	Investment income yield is defined in the glossary on page 175 and is reconciled on page 179.	Expresses a relationship between the investment income and the associated opening and closing assets adjusted for portfolio hedging instruments.
Investment return yield	Investment return	Investment return yield is defined in the glossary on page 175 and is reconciled on page 179.	Expresses a relationship between the investment return and the associated opening and closing assets net of any associated liabilities.
Loss ratio	Net insurance claims	Loss ratio is defined in the glossary on page 175 and is reconciled in note 4.	Expenses claims performance in relation to net earned premium.
Net investment income yield	Investment income	Net investment income yield is defined in the glossary on page 175 and is reconciled on page 179.	Expresses a relationship between the investment income and the associated opening and closing assets adjusted for portfolio hedging instruments.
Operating profit from Ongoing operations	Operating profit	Operating profit from Ongoing operations is defined as operating profit (see glossary on page 175) less operating profit from Run-off segment plus restructuring costs (note 4) and is reconciled on page 178.	This measure shows the underlying performance (before tax and finance costs) of the business activities without the impact of business that is in Run-off and restructuring costs.
Profit after tax from Ongoing operations	Profit after tax	Operating profit from Ongoing operations (as above) less finance costs and tax at standard rate and is reconciled on page 178.	This measure shows the underlying performance (after tax and finance costs) of the business activities without the impact of business that is in Run-off and restructuring costs.
RoTE	Return on Equity	RoTE is defined in the glossary on page 175 and is reconciled on page 178.	This shows underlying performance against a measure of equity that is more able to be compared with other companies.
Tangible equity	Equity	Tangible equity is defined as equity less intangible assets within the balance sheet and is reconciled on page 178.	This shows the equity excluding intangible assets for comparability with companies who have not acquired businesses or capitalised intangible assets.
Tangible net asset per share	Net assets per share	Tangible net asset per share is defined as tangible equity (as above) expressed as a value per share and is reconciled in note 16 on page 147.	This shows the equity excluding intangible assets per share for comparability with companies who have not acquired businesses or capitalised intangible assets.
Total costs from Ongoing operations	Operating expenses	Total costs from Ongoing operations is defined as operating expenses adjusted to remove restructuring costs and operating expenses charged to the Run-off segment (reconciled in note 10) plus claims handling expenses incurred in net insurance claims on Ongoing operations (note 8). This is reconciled on page 37.	This represents the total value of operating expenses including those allocated to the insurance claims line as claims handling expenses excluding business in Run-off and restructuring costs.

Appendix A – Alternative performance measures continued

Additionally, the current-year attritional loss ratio within the analysis by division section and total costs have also been identified as alternative performance measures, similarly reconciled to the financial statements and notes, on page 36, and defined in the glossary.

Return on tangible equity[1]

	Note[2]	2017 £m	2016 £m
Operating profit	4	642.8	390.2
Add back: restructuring costs	4	11.9	39.9
Exclude: operating profit from Run-off	4	(43.8)	(26.6)
Operating profit from Ongoing operations	4	610.9	403.5
Finance costs	11	(103.8)	(37.2)
Finance costs adjustment for one-off subordinated debt buy back		66.1	–
Adjusted profit before tax from Ongoing operations		573.2	366.3
Tax charge (using the UK standard tax rate of 19.25% and 20.0% respectively)		(110.3)	(73.3)
Adjusted profit after tax from Ongoing operations		462.9	293.0
Opening shareholders' equity		2,521.5	2,630.0
Opening goodwill and other intangible assets		(508.9)	(524.8)
Opening shareholders' tangible equity		2,012.6	2,105.2
Closing shareholders' equity		2,715.1	2,521.5
Closing goodwill and other intangible assets		(471.1)	(508.9)
Closing shareholders' tangible equity		2,244.0	2,012.6
Average shareholders' tangible equity[3]		2,128.3	2,058.9
Return on tangible equity		21.7%	14.2%

Adjusted diluted earnings per share[1]

	Note[2]	2017 £m	2016 £m
Adjusted profit after tax from Ongoing operations		462.9	293.0
Weighted average number of Ordinary Shares for the purpose of diluted earnings per share (millions)	15	1,379.0	1,381.8
Adjusted diluted earnings per share (pence)		33.6	21.2

Notes:

1. See glossary on pages 174 and 175 for definitions
2. See notes to the consolidated financial statements
3. Mean average of opening and closing balances

Investment income and return yields[1]

	Notes[2]	2017 £m	2016 £m
Investment income	6	167.1	167.9
Hedging to a sterling floating rate basis[3]	6	(27.0)	(17.1)
Net investment income		140.1	150.8
Net realised and unrealised gains excluding hedging	6	35.3	20.7
Investment return		175.4	171.5
Opening investment property		329.0	347.4
Opening financial investments		5,147.0	5,614.6
Opening cash and cash equivalents		1,166.1	963.7
Opening borrowings		(55.3)	(61.3)
Opening derivatives liability[4]		(5.8)	(45.7)
Opening investment holdings		6,581.0	6,818.7
Closing investment property	19	309.3	329.0
Closing financial investments	26	5,040.4	5,147.0
Closing cash and cash equivalents	27	1,358.6	1,166.1
Closing borrowings	27	(54.1)	(55.3)
Closing derivatives asset / (liability)[4]		55.1	(5.8)
Closing investment holdings		6,709.3	6,581.0
Average investment holdings		6,645.2	6,699.9
Investment income yield		2.5%	2.5%
Net investment income yield		2.1%	2.2%
Investment return yield		2.6%	2.6%

Notes:

1. See glossary on page 175 for definitions
2. See notes to the consolidated financial statements
3. Includes net realised and unrealised gains / (losses) of derivatives in relation to AUM
4. See note 1 on page 41

Forward-looking statements

This Annual Report & Accounts has been prepared for, and only for, the members of the Company as a body, and no other persons. The Company, its Directors, employees, agents or advisers do not accept responsibility to any other person to whom this document is shown, or into whose hands it may come, and any such responsibility or liability is expressly disclaimed.

Certain information contained in this document, including any information as to the Group's strategy, plans or future financial or operating performance, constitutes "forward-looking statements". These forward-looking statements may be identified by the use of forward-looking terminology, including the terms "aims", "ambition", "anticipates", "aspire", "believes", "continue", "could", "estimates", "expects", "guidance", "intends", "may", "mission", "outlook", "over the medium term", "plans", "predicts", "projects", "propositions", "seeks", "should", "strategy", "targets" or "will" or, in each case, their negative or other variations or comparable terminology, or by discussions of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this document and include statements regarding the intentions, beliefs or current expectations of the Directors concerning, among other things: the Group's results of operations, financial condition, prospects, growth, strategies and the industry in which the Group operates. Examples of forward-looking statements include financial targets and guidance which are contained in this document specifically with respect to the return on tangible equity; solvency capital ratio; the Group's combined operating ratio; prior-year reserve releases; cost reduction; reductions in expense and commission ratio; net investment income yield; net realised and unrealised gains; results from the Run-off segment; restructuring costs and risk appetite range. By their nature, all forward-looking statements involve risk and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future or are beyond the Group's control.

Forward-looking statements are not guarantees of future performance. The Group's actual results of operations, financial condition and the development of the business sector in which the Group operates may differ materially from those suggested by the forward-looking statements contained in this document, for example directly or indirectly as a result of, but not limited to, UK domestic and global economic business conditions, the outcome of the negotiations relating to the UK's withdrawal from the European Union, market-related risks such as fluctuations in interest rates and exchange rates, the policies and actions of regulatory authorities (including changes related to capital and solvency requirements or the Ogden discount rate), the impact of competition, currency changes, inflation and deflation, the timing impact and other uncertainties of future acquisitions, disposals, joint ventures or combinations within relevant industries, as well as the impact of tax and other legislation and other regulation in the jurisdictions in which the Group and its affiliates operate. In addition, even if the Group's actual results of operations, financial condition and the development of the business sector in which the Group operates are consistent with the forward-looking statements contained in this document, those results or developments may not be indicative of results or developments in subsequent periods.

The forward-looking statements in this document reflect knowledge and information available as of the date of preparation of this document. The Group and the Directors expressly disclaim any obligations or undertaking to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, unless required to do so by applicable law or regulation. Nothing in this document should be construed as a profit forecast.

Neither the content of Direct Line Group's website nor the content of any other website accessible from hyperlinks on the Group's website is incorporated into, or forms part of, this document.

Contact information

Registered office

Direct Line Insurance Group plc
Churchill Court
Westmoreland Road
Bromley
BR1 1DP

Registered in England and Wales No. 02280426
Company Secretary: Roger C Clifton

Telephone: +44 (0)1132 920 667
Website: www.directlinegroup.com

Registrars

Computershare Investor Services PLC
The Pavilions
Bridgwater Road
Bristol
BS99 6ZZ

Shareholder helpline: +44 (0)370 873 5880
Shareholder fax: +44 (0)370 703 6101
Telephone number for the hard of hearing:
+44 (0)370 702 0005
Website: www.computershare.com

Investor Centre
To find out more about Investor Centre, go to
www.investorcentre.co.uk/directline

Auditors

Deloitte LLP
Hill House
1 Little New Street
London
EC4A 3TR

Telephone: +44 (0)20 7936 3000
Website: www.deloitte.com

Legal advisers

Allen & Overy LLP
One Bishops Square
London
E1 6AD

Telephone: +44 (0)20 3088 0000
Website: www.allenovery.com

Slaughter and May
One Bunhill Row
London
EC1Y 8YY

Telephone: +44 (0) 20 7600 1200
Website: www.slaughterandmay.com

Principal banker

The Royal Bank of Scotland Group plc
280 Bishopsgate
London
EC2M 4RB

Telephone: +44 (0)131 556 8555
Website: www.rbs.com

Corporate brokers

Goldman Sachs International
Peterborough Court
133 Fleet Street
London
EC4A 2BB

Telephone: +44 (0)20 7774 1000
Website: www.goldmansachs.com

Morgan Stanley & Co. International plc
25 Cabot Square
Canary Wharf
London
E14 4QA

Telephone: +44 (0)20 7425 8000
Website: www.morganstanley.com

RBC Europe Ltd (trading as 'RBC Capital Markets')
Riverbank House
2 Swan Lane
London
EC4R 3BF

Telephone: +44 (0)20 7489 1188
Website: www.rbccm.com

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